THE "TAX GAP" AND TAXPAYER NONCOMPLIANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

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THE "TAX GAP" AND TAXPAYER NONCOMPLIANCE

THURSDAY, APRIL 19, 1990

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:38 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
FRIDAY, APRIL 6, 1990

PRESS RELEASE #27
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE FIRST IN A SERIES OF HEARINGS TO EXAMINE THE "TAX GAP" AND TAXPAYER NONCOMPLIANCE

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee on Oversight will conduct the first of a series of hearings to examine the "tax gap" and the extent to which taxpayers are not complying with Federal tax laws. The hearing is scheduled for Thursday, April 19, 1990, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m. The Subcommittee will receive testimony and reports from the Commissioner of the Internal Revenue Service (IRS), representatives of the U.S. General Accounting Office (GAO), and other invited witnesses.

The tax gap is an estimate of the difference between the amount of taxes voluntarily paid in a taxable year, and the amount of taxes that would have been paid if all taxpayers had filed complete and accurate returns. Noncompliance generally falls into four broad categories: failure to file returns; underreporting of income; overstating of deductions, credits and adjustments; and, failure to pay assessed tax liabilities.

According to the IRS's latest published estimates, the tax gap will exceed $113 billion, annually, by 1992. This figure, however, does not include amounts in the accounts receivable inventory, amounts owed from illegal income sources, such as drug dealing, amounts owed relating to employment or excise taxes, or amounts owed from any taxes other than the income tax. When all income sources are considered, the true size of the tax gap may be more than double the official estimates.

The Subcommittee on Oversight has focused its investigation on four major components of the tax gap. These components are: (1) sole proprietors, or those reporting business income on a Schedule C of an income tax return; (2) informal suppliers, or those operating on a cash basis without formal books and records; (3) small corporations, or those with assets under $10 million; and, (4) large corporations, or those with assets of $10 million or more. For each component, the Subcommittee investigated the types of taxpayers who were noncompliant, the specific tax issues of noncompliance involved, the IRS programs established to pursue noncompliance, and ways the IRS could improve its compliance efforts.

In announcing the hearing, Subcommittee Chairman Pickle stated: "Taxpayer noncompliance continues to escalate, forcing honest taxpayers to shoulder a disproportionate share of the country's revenue needs. The time has come to take strong action to preserve the integrity of our voluntary tax system by setting the record straight on who's not paying their fair share. The American taxpayer will not support a tax system that tolerates widespread cheating.

"For the past several years, the IRS has spent an enormous amount of time and effort recalculating its tax gap estimates. The IRS has employed new methodologies and excluded certain components of noncompliance to arrive at reduced estimates. Despite all this, the amount of money lost to the government continues to grow. The Subcommittee intends to move beyond the traditional analysis of the size of the tax gap, and focus on its specific components and ways to improve compliance and enforcement.

"To enhance compliance with our tax laws, we must reduce opportunities for cheating, ease the burden of compliance on honest taxpayers, improve the IRS's capability for detection and enforcement, and improve taxpayer knowledge of the tax laws. I expect the IRS to enforce the law, and to do so fairly. While I realize that no one loves the tax collector, the IRS must be firm with those who violate the law, and be supported in their effort. However, the Congress will not tolerate abuse or harassment of taxpayers by IRS. The IRS has an important job to do which must be conducted both fairly and effectively."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Interested parties are urged to submit written comments. Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, May 18, 1990, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515. Parties interested in making copies of their written statement available to the Subcommittee and the public at the hearing should submit 100 copies of their written statement, as outlined above, by the close of business, Tuesday, April 17, 1990.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. The Chair would ask the subcommittee to come to order.

The Chair will make an opening statement and would point out to our witnesses and guests this morning that the statement may be a little longer than usual, but it attempts to give you a rather broad picture of our concerns and our problems. Then we will proceed with our first witnesses.

On April 16, the vast majority of our law-abiding citizens timely filed their tax returns and paid their fair share of taxes. This is democracy at work. Everyone must and should pay their fair share. At the same time, there is a growing tendency for some not to pay their taxes. Some did not file returns and probably never will. Others filed returns and probably understated exactly their incomes, or wanted to. Others took excessive or illegal deductions, and some claimed fictitious refunds.

Unfortunately, there is a growing perception among honest taxpayers that everyone else is "out to beat the tax collector." I have seen reports which say that for every $100 in taxes paid by honest taxpayers, as much as $25 is lost due to deliberate tax avoidance, carelessness, illegal activities, and just plain taxpayer ignorance.

Today, the Subcommittee on Oversight begins a series of hearings to examine the extent to which taxpayers are not complying with our income tax laws, how they are abusing our tax system, and what can be done about it. The purpose of today's hearing is to set the record straight on who is not paying their fair share of taxes and who accounts for the largest portion of the tax gap. Our final objective is to report to the full committee our findings for dealing with specific components of taxpayer noncompliance.

Two years ago, this subcommittee held a similar hearing on the so-called tax gap. The tax gap is the estimate of how much money the IRS thinks is owed the Government above that which has been reported and collected. We learned from the Internal Revenue Service and the General Accounting Office that the tax gap is steadily increasing and will easily exceed $100 billion this year.

The $100 billion annual tax loss is on the conservative side and grossly misleading since the figure does not include—let me repeat, the $100 billion figure does not include: amounts in the $87 billion accounts receivable inventory—that is, taxes that are owed but not paid; the amounts owed from illegal activities such as drug dealing; amounts owed relating to employment or excise taxes; or amounts owed from any other tax other than the Federal income tax, such as estate and gift taxes. The total amount from all taxpayer noncompliance, reflecting all sources—if we are factual and will admit to it—may actually exceed over $200 billion a year.

In addition to the IRS figures, there are other studies which show an even larger, more rapidly growing noncompliance burden. One study—and this may be the Dorgan study, but I am not sure which one it was—but one study has pointed out that each year's tax gap is really a continuing liability that the IRS is free to collect, with interest, whenever it catches up with the noncompliant taxpayer. Accordingly, in the years since 1972, the cumulative present value of past tax gaps may be $1.6 trillion, an amount equal to about 60 percent of the entire Federal debt.

Continuation and escalation of taxpayer noncompliance will jeopardize this Nation's voluntary tax system. American taxpayers who voluntarily pay their fair share of the country's revenue needs will not support a tax system that tolerates widespread cheating. Taxpayers expect their Government to ensure that everyone pays their fair share. The public is entitled to no less.

With the enactment of the Tax Reform Act of 1986, the Taxpayer Bill of Rights, and civil tax penalty reform, a climate of cooperation should now exist between the taxpayer and the tax collector. The tax law is now significantly fairer and simpler as a result of these recent reform measures. Our objective now must be focused on improving compliance and strengthening enforcement. While we will not tolerate IRS harassment or mistreatment of taxpayers, neither should we permit less than fully effective compliance efforts by the IRS. The IRS must be tough on tax abusers, but fair. We are disturbed that the IRS has reduced funding for taxpayer assistance and various enforcement programs. We simply cannot do this and expect voluntary compliance to improve. Taxpayer assistance and compliance must be at the top of the list.

This year, the Oversight Subcommittee moved beyond the traditional analysis of the size of the tax gap. The amount of money involved is mind-numbing, and everyone agrees that experts are unable to determine with any certainty the true amount of lost revenue. Instead, the subcommittee focused its investigation on four components of the tax gap that comprise the largest share of noncompliance. These four categories are the informal suppliers, the sole proprietors, the small and large corporations. Followup hearings will be scheduled later this season on each of these areas. The subcommittee's investigation of corporate noncompliance, including U.S. subsidiaries of foreign corporations and transfer pricing issues, is still underway and is going to continue and will be the subject of hearings in the months ahead.

Today's hearing in the first step in understanding what comprises the tax gap and the adverse impact individual and corporate noncompliance are having on our tax system. We hope to learn more about who is not meeting their responsibilities and why. We will also explore what the IRS is doing to enhance compliance and what additional measures can be taken to preserve our voluntary tax system.

We are fortunate today to have the General Accounting Office report on the results of their investigation for the subcommittee on taxpayer noncompliance. I have read the GAO report. I believe it is the first thorough examination of the largest contributors to the tax gap and a profile of their behavior. I look forward to receiving the GAO testimony.

Now, the Chair will yield to Mr. Schulze for any statement.

Mr. SCHULZE. Thank you, Mr. Chairman. I am pleased to join you in opening today's hearing on the tax gap.

The term "tax gap" has no precise definition. It has evolved as a figure of speech in recent years. In general, the tax gap refers to the difference between what taxpayers actually owe in Federal income taxes and what they voluntarily pay.

The failure of individuals and businesses to pay their lawful income tax has several effects. First, it increases the burden on the law-abiding citizens to pick up the slack. Honest taxpayers wind up paying more than they otherwise would have to pay, similar to the retail store which must raise the cost of goods sold to all shoppers in order to cover the losses from shoplifters.

Second, the tax gap aggravates the Federal deficit. Unpaid taxes make the deficit larger than it should be. In fact, we are close to the point where the tax gap is comparable in size to the Federal deficit for fiscal year 1991. In theory, if we could erase the tax gap, we could erase most of the annual Federal deficits. But theory and reality don't always fit together in the real world.

At our tax gap hearing on March 17, 1989, we identified the general elements of the tax gap. They included understating income, overstating deductions, and not filing any tax return at all. Today, we will examine further the details of a few major components of the tax gap. In particular, we will concentrate on sole proprietors, informal suppliers, small corporations, and large corporations. Each of these groups has a different feature which we should understand better in order to address the tax gap.

In evaluating the reasons for the tax gap, we should not condemn all taxpayers as criminal tax evaders just because they are in a category identified in tax gap studies. There may be some taxpayers motivated by pure greed to cheat on their taxes, but, in my opinion, most people are decent and honest. Much of the tax gap may be rooted in the complex tax law which those honest businessmen simply cannot understand in all its details. What small business owner knows all the features of the passive loss rules or uniform capitalization rules?

We have the breeding ground for a vicious circle. The complexity of the tax law may breed noncompliance and contribute to the tax gap. But one standard response to the tax gap is to increase reporting requirements, and this may actually aggravate the complexity of the law. The solution to the tax gap probably will involve a delicate balance between increased enforcement and the limits of the public's endurance for intrusions into their daily lives. I am hopeful that our witnesses can help us to develop a balanced approach to addressing the tax gap.

Mr. Chairman, I look forward to hearing today's witnesses.

Chairman PICKLE. Thank you, Mr. Schulze.

Do any other members have opening statements? Mr. Dorgan.

Mr. DORGAN. Mr. Chairman, let me compliment you for holding these hearings. This subject, the tax gap, has had a long and tortured study over this past decade. We had a tax gap task force that looked at this and submitted a report that included contributions from two former Internal Revenue Service Commissioners, one Republican, one Democrat, Treasury officials, Joint Tax officials, and others. The next extension to that is to understand a little better exactly what is the tax gap. The question now is not so much what is it; it is what do we do about it. And I am hoping that these hearings will lead to some answers to those questions.

Let me make one final point. Some feel that the first thing to do about the tax gap is to enhance enforcement. That is certainly true. But enhanced enforcement alone will not solve the tax gap problem. You also must, it seems to me, increase taxpayer information and assistance. We need to extend a helping hand to help people complete their tax requirements and comply with the tax requirements, especially inasmuch as the Tax Code is not a very simple Tax Code. I am hoping that we can discuss much of that today with the Internal Revenue Service Commissioner.

Chairman PICKLE. Thank you, Mr. Dorgan. The Chair will say that it is my intention to make some kind of general proposal toward the end of the hearing today to see what we can do about this.

Now we will proceed with our first panel. We are glad to have with us again the Honorable Fred T. Goldberg, Jr., the Commissioner of the Internal Revenue Service.

We are pleased to hear your testimony, Mr. Commissioner. Will you, before you start, identify the individuals with you at the table?

STATEMENT OF HON. FRED T. GOLDBERG, JR., COMMISSIONER OF INTERNAL REVENUE, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY MICHAEL J. MURPHY, SENIOR DEPUTY COMMISSIONER; CHARLES H. BRENNAN, DEPUTY COMMISSIONER (OPERATIONS); AND JOHN D. JOHNSON, DEPUTY COMMISSIONER (PLANNING AND RESOURCES)

Mr. GOLDBERG. Thank you, Mr. Chairman. With me today are Mike Murphy, the Senior Deputy Commissioner; Charly Brennan, our Deputy Commissioner for Operations; and John Johnson, our chief financial officer.

Chairman PICKLE. We are glad to have all you gentlemen with us.

Mr. GOLDBERG. It is a pleasure to be here today, Mr. Chairman, to discuss the latest research on the tax gap and the efforts we are undertaking to enhance compliance with our tax laws.

The IRS, Congress, the administration, and the public have quite properly focused a great deal of attention on the tax gap. A $100 billion shortfall is certainly cause for concern, particularly in today's world of sizable deficits and Gramm-Rudman targets. At the same time, however, we must keep the tax gap in perspective. During 1989, the IRS collected over $1 trillion in revenue. Virtually all of these amounts were collected through self-assessment by taxpayers; our enforcement efforts accounted for less than $25 billion of the total.

The plain fact is that voluntary compliance has been and remains the backbone of our tax system. Our primary mission must be to maintain and enhance the health of that system by encouraging and facilitating voluntary compliance with our tax laws. While our enforcement efforts are essential—and they should be expanded—they are the most costly and the most intrusive means to that end. We cannot lose sight of the fact that a 1 percent swing in voluntary compliance will increase, or decrease, revenues each year by more than $5 billion.

Mr. Chairman, the focus of this hearing is on the net tax gap report that the IRS released today and on compliance issues relating to sole proprietors, informal suppliers, and small and large corporations. Before turning to these topics, I would like to offer a number of general observations.

We must pursue a balanced, long-term strategy of assistance, education, and enforcement. I am absolutely convinced that this approach will close a significant portion of the tax gap and will generate significant additional revenues for the Federal Government.

In particular, we must do everything we can to make it easier on the taxpaying public. Taxpayers are willing to pay what they owe. They cannot abide complexity, uncertainty, administrative burdens, and hassles with the IRS that may take months or years to resolve. To this end, we must modernize our computer systems to provide taxpayers with the kind of service that they have every right to demand and expect from their Government. We must simplify our laws, regulations, and administrative procedures. We must expand and continue to enhance the quality of our taxpayer assistance and education efforts.

At the same time, we must expand and enhance the quality of our enforcement activities. These efforts have a direct impact on revenue. Of equal importance, they have an indirect impact on revenue by encouraging voluntary compliance. To this end, we must respect the rights of taxpayers in every action we take; do a better job of targeting compliance initiatives at specific sectors of the tax gap; invest in the long-term and balanced growth of our enforcement functions; and modernize our computer systems to make better use of the information at our disposal.

We should provide our employees with the training and tools to do their jobs and remedy the gross inadequacies in pay for many Federal Government employees. We should work more closely and effectively with our colleagues in State and local tax administrations and with the tax professional community. Finally, we should consider legislation targeted at specific areas of noncompliance.

You and your colleagues have supported these efforts and this strategy for a number of years. Many are under way, and the administration's budget embodies a commitment to this strategy. At the same time, I want to emphasize there are no quick fixes. Our ability to deal effectively with the tax gap requires a long-term investment in the health of our tax system.

Mr. Chairman, I also believe that if we fail to make this investment, we will see a long-term erosion in voluntary compliance that will cost untold billions of dollars in lost revenue.

Our estimates of the total gross legal sector income tax gap range from $83 to $94 billion for tax year 1987. In other words, if all corporations and individuals fully and correctly reported all their legal sector income, did not overstate deductions and the like, and fully paid amounts when due, the IRS would have collected an extra $83 to $94 billion in income taxes during 1987.

The net income tax gap, which is the subject of the report we are releasing today, is that portion of the gross income tax gap that the IRS does not collect through enforcement measures. For tax year 1987, our enforcement efforts will bring in about $22 billion, leaving a net gap of $61 to $72 billion. Chart 1 at page 3 of my testimony shows the range of these estimates for the gross and net income tax gap for that year.

In reviewing these estimates, it is important to emphasize that they relate solely to income tax. Far and away, the largest component of revenues not covered is Social Security—including FICA, SECA, and the like. Chart 2, page 3 of my testimony, shows Federal revenues by source for 1987. As you can see, income taxes account for 64 percent, and employment taxes count for 31 percent. That is, 95 percent of the revenues are in those two categories.

We are preparing tax gap estimates for several of these areas, as well as for the illegal sector, and will be issuing reports on certain of these components later this year. We should point out, however, that compliance with respect to payroll taxes, the second biggest component of Federal revenue, is likely to be extremely high.

It is also important to note that the tax gap is not the same as our accounts receivable inventory. Our accounts receivable inventory consists of taxes, penalties, and interest that have been assessed by the IRS, but not yet paid. Unlike the 1-year tax gap, accounts receivable include interest and penalties, as well as assessments relating to many tax years and all types of taxes. Only that portion of the tax gap which is assessed passes through the accounts receivable inventory.

Now, the focus of this hearing is on four specific sectors of the net tax gap. The remainder of my testimony will address these components. We define these sectors as follows:

A sole proprietor is an individual who should file a schedule C to report business income and expenses. Generally, these types of taxpayers have a fixed business location and provide goods or services to the public. Common types of schedule C filers are merchants, professionals, tradesmen, and restaurant operators. For 1987, 13.9 million returns with schedule C's were filed. Of this number, well over half had gross receipts under $100,000.

An informal supplier is a proprietor providing goods or services to the public, often dealing in cash and generally not maintaining a regular place of business, regular hours, and the like. Informal suppliers also should file schedule C to report their income and expenses, and those who do file these schedules are included in the 13.9 million returns I have mentioned. The types of informal suppliers accounting for most of this component of the tax gap are those who make home repairs, provide child care, or sell food at the roadside.

The IRS classifies a company as a small corporation if it reports less than $10 million in assets. Over 2.7 million returns were filed by small corporations in 1987.

For purposes of our testimony, I am using the GAO definition to describe a large corporation as one which reports $10 million or more in assets. Approximately 46,000 large corporate returns were filed in 1987. Chart 3 summarizes the "contribution," so to speak, that these business sectors make to the tax gap.

If you look at page 4 of my testimony, you will see that of the entire tax gap, small corporations account for $5.4 billion and 5.7 percent; large corporations account for $16.8 billion and 17.8 percent; and unreported income by informal suppliers and sole proprietors accounts for some $24 billion and 26 percent of the tax gap. I should note that some of the other categories, such as nonfilers and overstated deductions, a portion of those amounts, will also be attributable to informal suppliers and sole proprietors.

Based on the foregoing, Mr. Chairman, your focus on the four identified areas is most appropriate. They involve relatively low levels of compliance and account for almost half of the gross income tax gap. To draw the point in its most stark form, the compliance rate on interest, dividends, and wages is 99 percent; the compliance rate on unreported income by informal suppliers and sole proprietors is 40 percent.

Legislation and our enforcement efforts during the 1980's have dramatically improved the already very high rates of compliance among taxpayers whose only sources of income are wages, interest, dividends, pensions, and/or capital gains from the sale of publicly traded securities—and whose only deductions, if any, are largely home mortgage interest expense. While this improvement is wholly appropriate, it makes it all the more important to focus our attention on areas of persistent noncompliance.

Before addressing each of the four sectors, I would like to note a number of common themes. During the past 20 years, audit coverage in each of these areas has declined dramatically. Chart 4 sets forth audit coverage in 1978, 1988, and 1989. You will note that audit coverage of sole proprietors and informal suppliers fell from more than 3 to 2 percent. Audit coverage of small corporations fell from 7.4 to 1.6 percent. Audit coverage of large corporations has fallen from 47.8 to 25.5 percent.

There is not much to say on this score; the numbers speak for themselves. They are an obvious cause for concern and highlight the critical importance of the administration's budget initiatives for fiscal year 1991. It will take many years to restore audit coverage to appropriate levels. It is high time we start.

With respect to our examination activities, one point worth noting is that our yield and revenue figures reflect only the direct results of our efforts—that is, the amount collected from the taxpayer as a result of an audit. It is obvious that there is also an indirect yield: taxpayers not subject to examination are more likely to comply if our overall audit activities increase. Recent studies indicate that this indirect yield is at least 1 to 1, and may be as high as 7 to 1. In other words, for each additional $100 million that we collect from taxpayer examinations, voluntary compliance by other taxpayers will increase by somewhere between $100 million and $700 million.

The second general point I would like to note relates to the employee/independent contractor issue. The misclassification of employees as independent contractors is a critically important compliance issue affecting small businesses. Several points are worth noting.

Compliance rates among individuals purporting to do business as "self-employed"—that is, sole proprietors and informal suppliers—are very low. Properly reclassifying these individuals would dramatically improve compliance and generate significant additional revenue. It should be noted that State and local governments would be a primary beneficiary of this effort through the generation of additional revenue at that level.

Current uncertainties in the law, coupled with the section 530 provisions, seriously disadvantage the many small businesses that properly treat their workers as employees. In some cases, the impact of misclassifying employees is to remove the social safety net from beneath low-paid individuals. As a practical matter, some of these workers treated as independent contractors are denied the benefits of Social Security, the earned income credit and the child care credit, and unemployment insurance.

Mr. Chairman, we are quite sensitive to the concerns of certain small businesses that believe they would be harmed by reclassification of their workers as employees. Nonetheless, as the IRS, GAO, and others have testified before, it may be appropriate to revisit this issue in a careful and evenhanded manner.

While our enforcement efforts generate significant revenues and close more than 20 percent of the tax gap, it is clear that we need to refine our approach and to rethink some of our basic strategies. For example, in conducting our enforcement activities, we must protect and maintain the rights of taxpayers. We must minimize taxpayer costs and inconvenience. These attitudes and values will not undermine our efforts. They are the key to effective enforcement and improved voluntary compliance.

We need to focus more of our compliance efforts—including research, taxpayer service and education, and enforcement—on patterns of taxpayer behavior, specific taxpayer needs and particular issues.

Finally, we need to view all of our enforcement efforts as part of a single process, breaking down the barriers that separate our examination, criminal investigation, appeals, counsel and collection functions.

I believe we are making progress in all of these areas. At the same time, it is clear we have a long way to go.

Now, while enforcement efforts are important, improved compliance by all types of business enterprises requires a balanced approach. For example, while complexity, uncertainty, and administrative burdens affect many taxpayers, they are particularly troublesome for sole proprietors and small corporations. We are confident that compliance can be greatly improved through enhanced taxpayer service and educational efforts. To this end, we have a number of initiatives under way.

We are conducting small business tax workshops on our own and in cooperation with the Small Business Administration and local business groups. Their purpose is to educate newly opened small businesses about their obligations, their recordkeeping requirements, payroll taxes, tax advantages and disadvantages of various forms of doing business, and the like. These workshops had 63,000 small business attendees in 1989. This is a package of the material we use, Mr. Chairman. It is a serious and I think a very high quality effort.

We are developing and testing a number of additional educational materials and techniques to assist small businesses, such as a software package that will produce an individualized tax calendar, and a small business newsletter.

We are convinced that these and similar efforts, as well as systems modernization and material simplification of the tax laws, are essential if we are to improve voluntary compliance.

I will now turn to the four areas you have identified. For our purposes, we have grouped together sole proprietors and informal suppliers since many of the issues are similar.

A portion of the tax gap in these areas results from overstated deductions; however, most of the shortfall is attributable to unreported income. While our traditional enforcement efforts are reasonably effective at detecting the former, it is extremely difficult to detect unreported income through traditional enforcement efforts. Nonetheless, we do have a number of initiatives under way that hold promise for the future.

For example, we have an examination initiative focused on schedule C filers with over $100,000 in gross receipts, based on research findings that those taxpayers account for large amounts of unreported income.

We have an examination initiative focused on schedule C filers involved in the direct sale of goods. This initiative was started based on recent experience indicating that direct sellers have been improperly creating business losses to offset other forms of income.

With our tax shelter work diminishing and our new hires becoming fully trained, we are devoting more effort to local compliance projects that identify informal suppliers. Initial indications are that these efforts are quite productive and that, but for lack of funding, some would be appropriate for nationwide implementation.

Special compliance teams in our service centers have been reviewing returns filed since 1988 in order to detect compliance issues arising under the Tax Reform Act of 1986. This up-front identification of emerging trends will permit us to better focus our enforcement efforts. These teams have identified situations where schedule C filers have improperly deducted startup costs, and have shifted employee business expenses to schedule C to avoid the 2 percent floor in miscellaneous deductions. As a result, we will be targeting these issues in our forms development, educational efforts, and examination activities.

Information return documents play a central role in discovering unreported income. During the 1980's, most of our efforts in this area focused on unreported wages, interest and dividends, and other easy-to-target areas. We are now expanding our use of information return documents and other available information sources to focus on unreported income by informal suppliers and sole proprietors. To cite but two examples, we are now cross-matching employee identification and Social Security numbers, and are making greater use of publicly available business and vendor license data maintained by State and local governments. My personal view is that we have barely scratched the surface in this area, and that we should make considerable progress in the years ahead. Unfortunately, much of our progress must await modernization of our computer systems. Our outmoded technology simply precludes the efficient and effective use of available information.

In addition to the decline in audit coverage, there has also been a decline in criminal prosecutions. This is a major enforcement tool with respect to the underreporting of business income. It may well be that additional efforts in this area are warranted.

Finally, legislation targeted at noncompliance in these areas is also appropriate. Legislation enacted last year relating to child care providers was one effort along these lines. We are currently working with Treasury in exploring other areas.

With respect to small corporations, in the case of unreported income, the approaches I have already described are appropriate. With respect to more traditional issues, an approach we think is particularly promising involves audit specialization. Our large case industry specialization program has been in place for some time and has proved quite effective. We believe that similar benefits can be obtained with respect to certain types of small businesses and industries. On the basis of a number of audits, we are developing guidelines that will be applicable to similarly situated taxpayers, resulting in greater uniformity and higher quality examinations.

Now, we devote a significant portion of our examination resources to large corporations. For example, during 1989 approximately three million corporations filed income tax returns. We will devote more than 25 percent of our examination resources to the top 1,500.

Large corporate returns raise exceptionally complex administrative and technical issues, and their examination is labor- and expertise-intensive. In some respects, however, the large case program is also our most productive: more than half the proposed adjustments from our entire examination program involve large companies. At the same time, however, there are a number of serious questions regarding the quality and bottom line results in this area. For example, agreement rates at the examination stage in our large case program have declined from more than 70 percent 15 years ago to less than 20 percent today. Issues that are not resolved at the examination stage may not be resolved for 10 or 15 years after the return in question was filed; and when resolved, our recovery rates are less than 25 percent and our sustention rates are less than 35 percent.

In response to these concerns, we have undertaken a comprehensive review of our entire large case program. A report containing an analysis of this entire area, and recommending fundamental changes in our approach to the large case program, has been submitted to IRS senior management and distributed to the affected taxpayers and practitioners for comment. I believe this report reflects our commitment to improving tax administration and a willingness to change with the times. We have requested the views of those affected, before we make any final decisions, because we are open to suggestions and we are willing to listen—two qualities that are essential if we are to do our job properly. I believe that this represents a critically important effort by the Service. If we properly address this area, we will enhance tax administration and compliance for many years to come. We would, of course, be happy to share a copy of the report with you and your staff.

[The report is at page 24.]

Mr. GOLDBERG. Before concluding, I would like to point out that large corporations also suffer from complexity, uncertainty, administrative burdens, and IRS hassles in dealing with our tax system. These same factors also erode compliance by large companies. Once again, our approach to compliance by large corporate taxpayers must be balanced and must focus on making things easier for those who are trying to comply with the law.

Mr. Chairman, as always, you and your colleagues are focused—and are causing us to focus—on matters of great importance. Sometimes it is difficult to get beyond the flood of numbers, studies, reports, and the like. But I really think a lot of this stuff is quite straightforward.

While our tax system functions remarkably well, we face an annual tax gap of around $100 billion. If we take the following steps, we will collect much of that revenue through voluntary compliance and our enforcement efforts: modernize our computer systems; expand and enhance the quality of our taxpayer service and educational programs; expand and enhance the quality of our enforcement efforts across the board; and simplify our laws, regulations, and administrative procedures.

We can, and we should, talk about and study a wide variety of compliance issues. But the real question is whether we have the will to invest in the long-term health of our tax system.

Thank you very much, Mr. Chairman. We would be happy to answer questions.

[The prepared statement and attachments follow:]

Statement of Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
Before the Subcommittee on Oversight
House Ways and Means Committee
April 19, 1990

I am pleased to appear before you today to discuss our latest research on the tax gap and the efforts we are undertaking to enhance compliance with our tax laws. With me today are Michael J. Murphy, Senior Deputy Commissioner, Charles H. Brennan, Deputy Commissioner (Operations) and John D. Johnson, Deputy Commissioner (Planning and Resources). We will be happy to answer any questions you might have at the conclusion of my testimony.

I. Overview -- The IRS, Congress, the Administration and the public have quite properly focused a great deal of attention on the tax gap. A $100 billion dollar shortfall is certainly a cause for concern -- particularly in today's world of sizeable deficits and Gramm-Rudman targets. At the same time, however, we must keep the tax gap in perspective. During 1989 the IRS collected over one trillion dollars in revenue. Virtually all of these amounts were collected through self-assessment by taxpayers; our enforcement efforts accounted for less than $25 billion of the total.

The plain fact is that voluntary compliance has been and remains the backbone of our tax system. Our primary mission must be to maintain and enhance the health of that system by encouraging and facilitating voluntary compliance with our tax laws. While our enforcement efforts are essential, and should be expanded, they are the most costly and intrusive means to that end. We cannot lose sight of the fact that a one percent swing in voluntary compliance will increase -- or decrease -- revenues each year by more than $5 billion.

Mr. Chairman, the focus of this hearing is on the net income tax gap report that the IRS released today, and on compliance issues relating to sole proprietors, informal suppliers, and small and large corporations. But before turning to these topics, I would like to offer a number of general observations.

We must pursue a balanced, long term strategy of assistance, education and enforcement. I am absolutely convinced that this approach will close a significant portion of the tax gap and generate significant additional revenues for the federal government. In particular:

- We must do everything we can to make it easier on the taxpaying public. Taxpayers are willing to pay what they owe; they cannot abide complexity, uncertainty, administrative burdens, and hassles with the IRS that may take months or years to resolve. To this end, we must:
    - Modernize our computer systems to provide taxpayers with the kind of service that they have every right to demand and expect from their government;
    - Simplify our laws, regulations, and administrative procedures;
    - Expand and continue to enhance the quality of our taxpayer assistance and education efforts.
- At the same time, we must expand and enhance the quality of our enforcement activities. These efforts have a direct impact on revenue; of equal importance, they have an indirect impact on revenue by encouraging voluntary compliance. To this end, we must:

-- Respect the rights of taxpayers in every action we take;

-- Do a better job of targeting compliance initiatives at specific sectors of the tax gap;

-- Invest in the long-term and balanced growth of our enforcement functions;

-- Modernize our computer systems to make better use of the information we have at our disposal.

o We should provide our employees with the training and tools to do their jobs, and remedy the gross inadequacies in pay for many federal government employees.

o We should work more closely and effectively with our colleagues in state and local tax administration and with the tax professional community.

o Finally, we should consider legislation targeted at specific areas of noncompliance.

You and your colleagues have supported these efforts for a number of years. Many are underway, and the Administration's budget embodies a commitment to this strategy. At the same time, I want to emphasize that there are no quick fixes; our ability to deal effectively with the tax gap requires a long-term investment in the health of our tax system.

Mr. Chairman, I also believe that if we fail to make this investment, we will see a long-term erosion in voluntary compliance that will cost untold billions of dollars in lost revenue.

I would now like to turn to the specific topics under consideration at today's hearing.

II. Gross and Net Tax Gap Estimates

Our estimates of the total gross legal sector income tax gap range from $83 to $94 billion for Tax Year 1987. In other words, if all corporations and individuals fully and correctly reported all their legal sector income, did not overstate deductions and the like, and fully paid amounts owed when due, the IRS would have collected an extra $83 to $94 billion in income taxes for Tax Year 1987.[1]

The net income tax gap, which is the subject of the report we are releasing today, is the portion of the gross income tax gap that the IRS does not collect through various enforcement measures. For Tax Year 1987, these efforts will bring in about $22 billion, leaving a net gap of $61 to $72 billion. Chart 1 shows the range of estimates for the gross and net income tax gap for 1987.

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[1] Our March 1988 report estimated the gross income tax gap at $71 to $85 billion; our revised estimates for that range is now $74 to $85 billion. These estimates do not include the remittance gap -- amounts voluntarily reported as due and owing but not paid. Based on our remittance gap estimate for 1987 of $9 billion, our estimates of the gross income tax gap for that year range from $83 to $94 billion.

Chart 1. Range of Estimates, Gross and Net Legal Sector Income Tax Gap (1987), $$ in Billions

	Lower Estimate	Higher Estimate
Total Income Taxes Due:	494	505
Voluntary Payments:	411	411
Gross Tax Gap:	83	94
Enforcement Revenues:	22	22
Net Tax Gap:	61	72

In reviewing these estimates, it is important to emphasize that they relate solely to income taxes. Far and away, the largest component of revenues not covered is Social Security (including FICA, SECA, and the like). Chart 2 shows revenues, by source, for 1987.

Chart 2. Internal Revenue Collections by Source, FY 1987 ($$ in Billions)

Revenue Source	Amount	Percent of Total
Income Tax	568	64.1
Employment Tax	277	31.3
Estate and Gift Tax	8	0.9
Excise Tax	21	2.4
Other	12	1.4

We are preparing tax gap estimates for several of these sources of revenue, as well as for the illegal sector, and anticipate issuing a report on certain of these components of the overall tax gap later this year. We should point out, however, that compliance with respect to payroll taxes is likely to be quite high.

It is also important to note that the tax gap is not the same as our accounts receivable inventory. Our accounts receivable consists of taxes, penalties and interest that have been assessed by the IRS, but not yet paid. Unlike the one-year tax gap, accounts receivable include interest and penalties, as well as assessments relating to many tax years and all types of taxes. Only that portion of the tax gap which is assessed passes through the accounts receivable inventory.

III. Noncompliance Among Sole Proprietors Informal Suppliers. And Small and Large Corporations

The focus of this hearing is on noncompliance among sole proprietors, informal suppliers, and small and large corporations. Accordingly, the remainder of my testimony will address these components of the tax gap. For our purposes, we define these business sectors as follows:

A sole proprietor is an individual who should file a Schedule C to report business income and expenses. Generally, these types of taxpayers have a fixed business location and provide goods or services to the public. Common types of Schedule C filers are merchants, professionals, tradesmen and restaurant operators. For TY 1987, 13.9 million returns with Schedule C's were filed. Of this number, well over half had gross receipts under $100,000.

An informal supplier is a proprietor providing goods or services to the public, often dealing in cash and generally not maintaining a regular place of business, regular hours, and the like. (Informal suppliers also should file Schedule C to report their income and expenses. Those who do file these schedules are included in the 13.9 million mentioned above.) The types of informal suppliers accounting for most of this component of the tax gap are those who make home repairs, provide child care, or sell food at the roadside.

The IRS classifies a company as a small corporation if it reports less than $10 million in assets. Over 2.7 million returns were filed by small corporations in TY 1987.

For purposes of my testimony, I am using the GAO definition to describe a large corporation as a corporation which reports $10 million or more in assets. Approximately 46,000 large corporate returns were filed in 1987.

Chart 3 summarizes the "contribution" that these business sectors make to the tax gap.

Chart 3. Components of Legal Sector Income Tax Gap (1987)

	Compliance Rate Percent	Tax Gap $ Billion	Tax Gap Percent
Individual			
Small Corporations	75.5	5.4	5.7
Large Corporations	82.3	16.8	17.8
Unreported Income by Informal Suppliers and Sole Proprietors	41.4	24.3	25.8
Overstated Deductions, Adjustments and Exemptions*	n/a	6.1	6.4
Nonfilers*	n/a	7.2	7.6
Remittance Gap*	n/a	7.9	8.4
Wages, Interest and Dividends	99.0	4.3	4.6
Capital Gains	88.3	6.7	7.1
Other Business Income**	n/a	6.4	6.7
Other	n/a	9.1	9.7
Total	n/a	94.2	100.0

* Some of these amounts are attributable to taxpayers who are sole proprietors or informal suppliers.

** Partnership income, S-corporation income, net rental income, and net royalty income.

Based on the foregoing, your focus on the four identified areas is most appropriate. They involve relatively low levels of compliance and account for almost half the gross income tax gap. They also represent the most challenging and difficult areas for enforcement and improved voluntary compliance.

Legislation and our enforcement efforts during the 1980's have dramatically improved the already high rates of compliance among taxpayers whose only sources of income are wages, interest, dividends, pensions, and/or capital gains from the sale of publicly traded securities -- and whose only deductions (if any) are largely home mortgage interest expense. While wholly appropriate, this makes it all the more important to focus on areas of persistent noncompliance.

1. Some Common Themes. Before addressing each of the four sectors you are considering today, a number of common themes are worth noting.

(A) Audit Coverage. During the past twenty years, audit coverage in each of these areas has declined dramatically. Chart 4 sets forth audit coverage in 1978, 1988 and 1989.

Chart 4. Audit Coverage for Selected Years,

Various Business Sectors

year	Sole Proprietors Informal Suppliers*	Small Corps.	Large Corps.
1978	3.09	7.42	47.82
1988	2.21	0.92	25.79
1989	2.00	1.61	25.51

* Examination statistics are not maintained in these precise categories. For purposes of this table, the audit coverage rates shown for sole proprietors and informal suppliers is the audit coverage rate for individuals whose principal source of income is non-farm business income.

There's not much to say on this score; the numbers speak for themselves. They are an obvious cause for concern, and highlight the critical importance of the Administration's budget initiatives. It will take many years to restore audit coverage to appropriate levels; it's high time we start.

With respect to our examination activities, one point worth noting is that our yield and revenue figures reflect only the direct results of our efforts -- i.e., the amount collected from the taxpayer as a result of the audit. It is obvious that there is also an indirect yield -- taxpayers not subject to examination are more likely to comply if our overall audit activities increase. Recent studies indicate that this indirect yield is at least one-to-one, and may be as high as seven to one. In other words, for each additional $100 million that we collect from taxpayer examinations, voluntary compliance by other taxpayers will increase by somewhere between $100 million and $700 million.

(B) Employee/Independent Contractor Issues. The misclassification of employees as independent contractors is a critically important compliance issue affecting small businesses. Several points are worth noting in this regard:

-- Compliance rates among individuals purporting to do business as "self-employed" (i.e., sole proprietors and informal suppliers) have very low compliance rates. Properly reclassifying these individuals would dramatically improve compliance and generate significant additional revenue. It should be noted that state and local governments would also generate significant additional revenue from this effort.

-- Current uncertainties in the law, coupled with the section 530 provisions, seriously disadvantage those small businesses that properly treat their workers as employees.

-- In some cases, the impact of misclassifying employees is to remove the social safety net from beneath low paid individuals. As a practical matter, some of these workers treated as independent contractors are denied the benefits of social security, earned income and child care credits, and unemployment insurance.

Mr. Chairman, we are quite sensitive to the concerns of certain small businesses that believe they would be harmed by reclassification of their workers as employees. Nonetheless, as the IRS, GAO, and others have testified before, it may be appropriate to revisit this issue in a careful and even handed manner.

(C) Rethinking Our Enforcement Strategies. While our enforcement efforts generate significant revenues and close more than 20% of the tax gap, it is clear that we need to refine our approach and rethink some of our basic strategies. For example:

-- In conducting our enforcement activities, we must protect and maintain the rights of taxpayers; we must minimize taxpayer costs and inconvenience. These attitudes and values will not undermine our efforts -- they are the key to effective enforcement and improved voluntary compliance.

-- We need to focus more of compliance efforts (research, taxpayer service and education, and enforcement) on patterns of taxpayer behavior, taxpayer needs and particular issues.

-- We need to view all of enforcement efforts as part of a single process, breaking down the barriers that separate our Examination, Criminal Investigation, Appeals, Counsel and Collection functions.

I believe we are making progress in all of these areas; at the same time, it is clear that we have a long way to go.

(D) The Need for Balance. While enforcement efforts are important, improved compliance by all types of business enterprises requires a balanced approach. For example, while complexity, uncertainty and administrative burdens affect many taxpayers, they are particularly troublesome for sole proprietors and small corporations. We are confident that compliance can be greatly improved through enhanced taxpayer service and educational efforts. To this end, we have a number of initiatives underway. For example:

-- We are now conducting small business tax workshops on our own and in cooperation with the Small Business Administration and local business groups. Their purpose is to educate newly opened small businesses about their obligations regarding recordkeeping, payroll taxes, the tax advantages and disadvantages of various forms of doing business, and the like. These workshops had 63,000 small business attendees in 1989.

-- We are developing and testing a number of additional educational materials and techniques to assist small businesses, such as a software package that will produce an individualized tax calendar for taxpayers, and a small business newsletter.

We are convinced that these and similar efforts -- as well as systems modernization and material simplification of the tax laws -- are essential if we are to improve voluntary compliance.

2. Sole Proprietors and Informal Suppliers. A portion of the tax gap in these areas results from overstated deductions; however, most of the shortfall is attributable to unreported income. While our traditional enforcement efforts are reasonably effective at detecting the former, it is extremely difficult to detect unreported income through traditional enforcement efforts. Nonetheless, we do have a number of initiatives underway that hold promise for the future. For example:

-- We have an examination initiative focused on Schedule C filers with over $100,000 in gross receipts, based on research findings that those taxpayers account for large amounts of unreported income.

-- We have an examination initiative focused on Schedule C filers involved in the direct sale of goods. This initiative was started based on recent experience indicating that direct sellers have been improperly creating business losses to offset other forms of income.

-- With our tax shelter work diminishing and our new hires becoming fully trained, we are devoting more effort to local compliance projects that identify informal suppliers. Initial indications are that these efforts are quite productive and that (but for lack of funding) some would be appropriate for nationwide implementation.

-- Special compliance teams in our service centers have been reviewing returns filed since 1988 in order to detect compliance issues arising under the Tax Reform Act of 1986. This up front identification of emerging trends will permit us to better focus our enforcement efforts. These teams have identified situations where Schedule C filers have improperly deducted start-up costs, and have shifted employee business expenses to Schedule C to avoid the 2% floor in miscellaneous deductions. As a result, we will be targeting these issues in our forms development, educational efforts, and examination activities.

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-- In addition to the decline in audit coverage, there has also been a decline in criminal prosecutions. Criminal prosecution is a major enforcement tool with respect to underreporting of business income. It may well be that additional efforts in this area are warranted.

-- Legislation targeted at non-compliance in these areas may also be appropriate. Legislation enacted last year relating to child care providers was one effort along these lines. We are currently working with Treasury in exploring other areas.

3. Small Corporations. In cases of unreported income, the approaches I have already described are appropriate for small corporations as well. With respect to more traditional issues,

an approach we think is particularly promising involves audit specialization. Our Large Case Industry Specialization Program has been in place for some time, and has proved quite effective. We believe that similar benefits can be obtained with respect to certain types of small businesses and industries. On the basis of a number of audits, we are developing guidelines that will be applicable to similarly situated taxpayers, resulting in greater uniformity and higher quality examinations.

4. Large Corporations. We devote a significant portion of our Examination resources to large corporations. For example, during 1989 approximately 3,000,000 corporations filed income tax returns -- we will devote more than 25% of our Examination resources to the top 1,500.

Large corporate returns raise exceptionally complex administrative and technical issues, and their examination is labor and expertise intensive. In some respects, however, the large case program is also our most productive: more than half of the proposed adjustments from our entire examination program involve large companies. At the same time, however, there are a number of serious questions regarding the quality and bottom line results in this area. For example: agreement rates at the examination stage in our large case program have declined from more than 70% fifteen years ago to less than 20% today. Issues that are not resolved at the examination stage may not be resolved for ten or fifteen years after the return in question was filed -- and when resolved, our recovery rates are less than 25% and our suspension rates are less than 35%.

In response to these concerns, we have undertaken a comprehensive review of our entire large case program. A report containing an analysis of this entire area, and recommending fundamental changes in our approach to the large case program, has been submitted to IRS senior management and distributed to affected taxpayers and practitioners for comment. I believe this report reflects our commitment to improving tax administration and a willingness to change with the times. We have requested the views of those affected, before we make any final decisions, because we are open to suggestions and willing to listen -- two qualities that are essential if we are to do our job properly. I believe that this represents a critically important effort by the service. If we properly address this area, we will enhance tax administration and compliance for many years to come. We would of course be happy to share a copy of the report with you and Subcommittee staff.

Before concluding, I would like to point out that large corporations also suffer from complexity, uncertainty, administrative burdens and IRS hassles in dealing with our tax system. These same factors also erode compliance by large companies. Once again, our approach to compliance by large corporate taxpayers must be balanced and must focus on making things easier for those that are trying to comply with the law.

Conclusion

Mr. Chairman, as always, you and your colleagues are focused -- and are causing us to focus -- on matters of great importance to our tax system. Sometimes it is difficult to get beyond the flood of numbers, studies, reports, and the like. But I think that a lot of this stuff is really quite straight-forward.

While our tax system functions remarkably well, we face an annual tax gap of around $100 billion. If we take the following steps, we will collect much of that revenue through voluntary compliance and our enforcement efforts:

-- Modernize our computer systems;

-- Expand and enhance the quality of our taxpayer service and educational programs;

-- Expand and enhance the quality of our enforcement efforts across the board;

-- Simplify our laws, regulations and administrative procedures.

We can, and should, talk about and study a wide variety of compliance issues. But the real question is whether we have the will to invest in the long term health of our tax system.

Department
of the
Treasury
Internal
Revenue
Service

Income Tax Compliance Research

Net Tax Gap and Remittance Gap Estimates (Supplement to Publication 7285)

April 1990

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This report supplements the estimates of the gross tax gap published in March of 1988 (Publication 7285). It presents the corresponding estimates of the net tax gap (i.e., net of enforcement collections). This report also includes estimates of the remittance gap, which were not available for inclusion in the 1988 report.

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Executive Summary

The mission of the Internal Revenue Service (IRS) is "to collect the proper amount of tax revenue at the least cost . . . in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness." (See Document 6987.) To achieve this purpose, IRS must determine the extent of noncompliance with the tax law and regulations. IRS tax gap estimates are comprehensive measures of noncompliance that convey significant information about the challenges faced in collecting taxes that are not voluntarily paid. A proper understanding of the nature of the tax gap is important for the development of future IRS programs and revenue initiatives.

In 1988, IRS published a series of estimates of the "gross income tax gap," which is the amount of true income tax liability that is not voluntarily paid.[1] The principal purpose of this new report (which should be seen as a supplement to that gross tax gap report) is to present IRS's estimates of the "net income tax gap," which is the gross income tax gap less the amount of income taxes paid or collected as a direct result of IRS enforcement activity. These *net* income tax gap estimates represent the amount of income tax liability that will remain unpaid after all IRS enforcement activity has been completed for the tax year in question. Recovering more of the gross tax gap would require either that voluntary compliance improves or that IRS expand or improve its enforcement activities (or some combination of both). Although we cannot estimate *how much* of the net tax gap IRS could recover as a result of expanding its existing enforcement activities, we know that a significant portion of it could be collected cost-effectively through a balanced strategy that incorporates expanded and improved IRS programs (including taxpayer service, education, and enforcement), as well as compliance-oriented tax law changes (intended, for example, to reduce complexity and eliminate various opportunities for noncompliance). This report discusses the various difficulties inherent in detecting and collecting the remainder of the net tax gap, as well as the problems associated with estimating how much *could* be collected cost-effectively.

It is difficult for IRS to know in all cases what a taxpayer's "true" tax liability is. This is because examiners cannot always detect all noncompliance and—for a variety of legal and administrative reasons—some of the amount that *is* recommended, but is not assessed, may represent "true" noncompliance. Therefore, estimates of the tax gap are subject to significant uncertainty. For this reason, our 1988 report included a set of "alternate" estimates of the gross income tax gap in addition to our "primary" estimates. For the "primary" estimates, figures based on examinations of tax returns reflected the full amount of additional tax recommended by the examiners; for the "alternate" estimates, these figures were adjusted to allow for the portions of recommended tax deficiencies that are conceded in the appeals process or lost in litigation. We continue to show two sets of estimates for this report, but instead of referring to them as "primary" and "alternate," we show them as a range[2] of estimates—the "higher" tax gap estimates corresponding to our old "primary" estimates, and the "lower" tax gap estimates corresponding to our old "alternate" estimates. We have also re-estimated the old "alternate" estimates, because after those estimates were published, we found that the data used to make the adjustments were not current. The lower estimates given in this report, therefore, are based on more recent information.[3]

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[1] Internal Revenue Service, *Income Tax Compliance Research: Gross Tax Gap Estimates and Projections for 1973-1992*, Publication 7285, Washington, D.C., March 1988.

[2] By "range" we simply mean the difference between the two sets of estimates. The "true" tax gap need not lie

In most cases, the difference between the higher and lower estimates is relatively small. However, the uncertainty concerning true tax liabilities is particularly unsatisfactory with respect to the estimates for large corporations. Since we have assumed (for lack of data) that the examination program detects the entire gross tax gap for large corporations, and since large corporations pay virtually all of their assessments, this implies a higher estimate of the *net* tax gap which is almost exactly equal to the amount of tax deficiencies that is recommended by Examination but conceded in appeals or lost in litigation. For the same reason, the lower estimate of the gross tax gap for large corporations implies that the net tax gap is close to zero. This problem of estimating "true" tax liabilities (which is the basis for estimating the gross tax gap) for large corporations is the subject of several IRS research projects. We expect that future estimates will reflect the results of these studies.

All of these estimates include only taxes due on incomes earned in the legal sector of the economy. They do not include unpaid taxes due on illegally-earned incomes, nor do they include unpaid tax liabilities involving other types of federal taxes, such as estate and gift, employment, or excise taxes.[4] We do not have current estimates of the tax gaps in these other tax areas.[5]

Also included in this report are new estimates of a significant element of the gross income tax gap: the remittance gap. This is the amount of tax which is voluntarily reported by taxpayers but is not voluntarily paid—either because taxpayers fail to remit it with their returns, or because their employers fail to remit it after it is withheld. We now have the information needed to make these estimates, which were not included in the 1988 report. For 1987, the remittance gap estimate is $9.3 billion. (See Chapter IV for details.) The 1988 report gave a "primary" estimate of the gross legal-sector income tax gap for tax year (TY) 1987 of $84.9 billion and a corresponding "alternate" estimate of $71.2 billion (which we have re-estimated to be $73.2 billion, as discussed above). Thus, with the remittance gap included, our estimates of the total *gross* legal-sector income tax gap range from $82.5 billion to $94.2 billion. Our estimates of the corresponding *net* legal-sector income tax gap for TY 1987 range from $60.7 billion to $72.3 billion.

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within this range—especially if our assumptions concerning the detectability of tax deficiencies are not correct. If these assumptions *are* realistic, then the only other source of uncertainty concerns the ability of the examination-appeals-litigation process to arrive at the "true" tax liability. This is the uncertainty defined by the range in our two sets of estimates. See Chapter III for a discussion of these two sets of estimates.

[3] See Internal Revenue Service, *Evaluation of the IRS System of Projecting Enforcement Revenue*, Publication 1501, Washington , D.C., November 1989.

[4] For fiscal year (FY) 1987, income taxes accounted for 55.8 percent of federal budget receipts. Employment taxes accounted for another 35.5 percent, while excise and estate and gift taxes combined accounted for 4.7 percent. The remaining 4.0 percent came from customs duties and miscellaneous receipts. See Office of Management and Budget, *Historical Tables, Budget of the United States Government*, 1990, pp. 25, 37.

[5] However, we plan that our next tax gap report in this continuing series will contain estimates of the employment tax and illegal-sector income tax gaps.

I. Tax Gap Concepts

A. Gross Tax Gap

The amount of tax that is due but not voluntarily paid is the *gross tax gap*. This is comprised of the *reporting gap*, which is the amount of tax liability that taxpayers do not voluntarily report on their returns, and the *remittance gap*, which is the amount that taxpayers report on their returns as due, but which is not voluntarily paid—either because they do not remit it with their returns, or because their employers fail to remit what they withhold from their wages.[6] The percentage of tax liability voluntarily paid is the voluntary compliance rate (VCR).

Table 1 presents estimates of the gross legal-sector income tax gap and the associated VCRs for selected tax years from 1973 to 1992. As shown in Table 1, our estimates of the TY 1987 VCR range[7] from 83.6 percent to 81.7 percent. We estimate that taxpayers voluntarily paid $411.3 billion in legal-sector income taxes for TY 1987. Our estimates of what they did *not* voluntarily pay—the tax gap—range from $82.5 billion to $94.2 billion of their total income tax liability that year. The word "voluntarily" as used here means without any IRS enforcement action (such as examination, collection, or criminal investigation) taking place between the due date of the tax and the time of payment.

Fostering voluntary compliance with the Federal tax law is an important IRS objective. IRS seeks to maintain and improve voluntary compliance both through customer service activities and through enforcement programs.

Customer service activities account for approximately 40 percent of the IRS budget. These activities include such functions as taxpayer service, returns processing, and the administration of tax forms and publications. IRS customer service initiatives aimed at improving voluntary compliance have, over the last five to ten years, included such activities as expanded telephone assistance for taxpayers, improved taxpayer education (especially for new businesses), simplified tax forms, efforts to obtain the views of taxpayers concerning their needs, and more rapid and accurate processing of tax returns. These activities recognize that most taxpayers want to comply with the law, and IRS efforts in these areas are designed to make it as easy as possible for them to be fully compliant.

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[6] Note that neither the gross tax gap nor the remittance gap are synonymous with IRS's accounts receivable inventory, which is the amount of tax, penalties and interest that *has been assessed*, but has not yet been paid at a particular time. Unlike the tax gap, accounts receivable includes interest and penalties, as well as assessments related to many tax years and several types of taxes (some of which we do not have corresponding tax gap estimates for). Moreover, since a large part of the gross tax gap is *never* assessed, that portion will never become a part of accounts receivable. All of the remittance gap passes through accounts receivable (since, by definition, it is self-assessed), but the remittance gap relating to a particular tax year of liability is not necessarily all present in accounts receivable at any one time.

[7] The higher estimates of the VCR correspond to the lower estimates of the tax gap, and the lower estimates of the VCR correspond to the higher estimates of the tax gap.

Table 1. Range of Estimates of the Gross Legal-Sector Income Tax Gap[1] and Voluntary Compliance Rates (VCRs)[2], Selected Tax Years, 1973-1992

Tax Year	Gross Income Tax Gap (in $ billions)						Voluntary Compliance Rate (%)					
	Total		Individual Income Tax [3]		Corporate Income Tax [4]		Total		Individual Income Tax [3]		Corporate Income Tax [4]	
1973	27.9 *to*	32.0	22.0 *to*	22.7	5.9 *to*	9.3	83.9 *to*	82.0	83.0 *to*	82.6	86.6 *to*	80.3
1976	39.7	45.5	32.6	33.7	7.1	11.8	82.7	80.7	81.2	80.7	87.3	80.6
1979	61.0	69.0	51.5	53.2	9.6	15.9	81.9	80.0	80.3	79.8	87.2	80.4
1981	68.9	76.1	60.1	61.9	8.7	14.1	82.8	81.4	82.0	81.6	87.0	80.6
1982	64.6	70.5	57.5	59.1	7.1	11.4	82.9	81.7	82.2	81.8	87.1	80.8
1984	83.0	91.3	73.5	75.7	9.6	15.6	81.6	80.1	80.4	80.0	87.2	80.6
1986	96.1	105.6	86.0	88.8	10.1	16.8	81.0	79.5	79.7	79.2	87.7	81.1
1987	82.5	94.2	69.1	71.4	13.4	22.8	83.6	81.7	82.3	81.8	88.1	81.3
1988	84.5	96.8	70.3	72.6	14.2	24.3	84.0	82.0	82.7	82.3	88.1	81.2
1992	110.1	127.0	91.0	94.0	19.1	33.1	84.6	82.7	83.6	83.1	88.1	81.1

Some components do not add due to rounding.

1 The results of examinations of tax returns are used in estimating several parts of the tax gap. Where these results are used, the higher estimates of the tax gap (and the corresponding lower estimates of the voluntary compliance rate) are based on the amounts of additional tax recommended by IRS examiners, and the lower estimates of the gap (and the corresponding higher estimates of the VCR) are based on the amounts of tax ultimately assessed after all appeals and litigation. If we have correctly estimated the extent to which examiners cannot detect all tax deficiencies, then the "true" tax gaps (or VCRs) lie between these two sets of estimates. See Chapter III for a discussion of the two sets of estimates. The estimates include estimates of remittance gaps, which were not included in Publication 7285.

2 The Voluntary Compliance Rate is what taxpayers voluntarily pay as a percentage of their total tax liability.

3 Includes insufficient remittance by individuals *and* underdeposit of individual income tax withheld by employers.

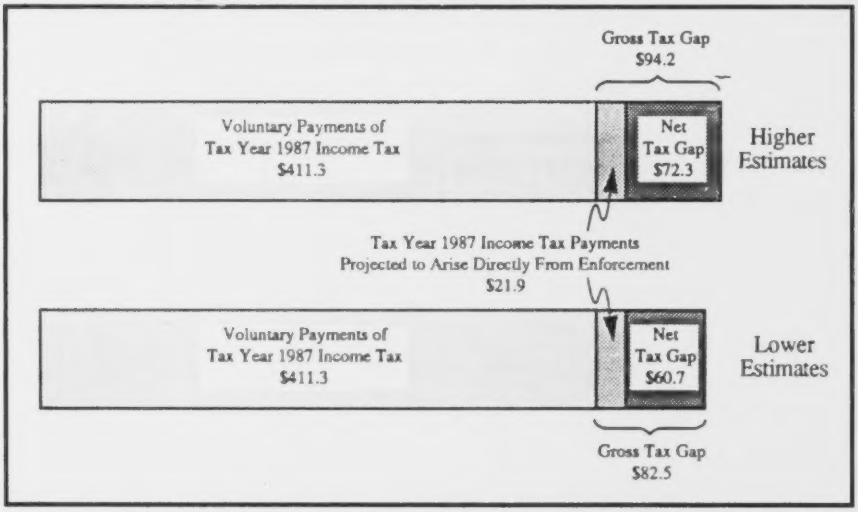
4 Includes fiduciaries' income tax and unrelated business income tax of tax-exempt organizations. The VCRs for all corporations combined fluctuates slightly—even though we have assumed constant compliance rates—because of the changing mix of small, mid-size, and large corporations over time.

Improving voluntary compliance is also a major goal of IRS enforcement programs. These programs seek to encourage voluntary compliance indirectly by: (a) improving the subsequent voluntary compliance of the specific taxpayers subjected to IRS enforcement programs; and (b) improving the voluntary compliance of taxpayers who are not directly affected by enforcement actions, but who nevertheless may become more compliant due to the general deterrent effect of IRS activity—the so-called "ripple effect." These indirect revenue effects of enforcement are very difficult to measure; we do not currently have estimates for them. We do, however, have estimates of the amount of additional tax which is involuntarily paid as a *direct* result of IRS enforcement activities.

B. Net Tax Gap

The net tax gap is the part of the gross tax gap that is not collected through IRS enforcement activities. As shown in Chart 1, our estimates of the net legal-sector income tax gap for TY 1987 range from $60.7 billion to $72.3 billion. The difference between these estimates and the corresponding gross tax gap estimates for the same year represents an estimated $21.9 billion of tax which will be collected as a result of current IRS enforcement activities.[8] IRS enforcement programs, although designed to encourage individual and corporate *voluntary* tax compliance, do nonetheless yield significant amounts of revenue directly. Some of these programs focus on taxpayers who file returns (filers), and some on taxpayers who fail to file returns (nonfilers).

Chart 1. Range of Estimates† of the Gross and Net Legal-Sector Income Tax Gap‡ (in billions), Tax Year 1987



† The results of examinations of tax returns are used in estimating several parts of the tax gap. Where these results are used, the higher estimates of the tax gap are based on the amounts of additional tax recommended by IRS examiners, and the lower estimates are based on the amounts of tax ultimately assessed after all appeals and litigation. If we have correctly estimated the extent to which examiners cannot detect all tax deficiencies, then the "true" tax gap lies between these two estimates. See Chapter III for a discussion of the two sets of estimates.

‡ All amounts refer to income tax only. Other taxes (such as employment taxes) are excluded. Voluntary payments were projected for the 1988 gross tax gap report, and have not been adjusted to reflect actual payments. Payments arising from enforcement are *projections* of what will be collected from tax year 1987 liabilities, and exclude interest and penalties.

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[8] Enforcement revenue includes penalties and interest collected, but since the gross tax gap is measured in terms of tax only, penalties and interest are not included in estimates of enforcement yield for the purpose of estimating the net tax gap.

The filer programs include: (a) examination of tax returns (which, in over 80 percent of the cases, involves face-to-face contact between IRS employees and taxpayers or their representatives); (b) computer matching of tax returns against third-party information documents (such as Form W-2 withholding statements filed by employers and Form 1099 interest statements filed by banks); (c) math error verification; (d) other computer-based adjustments of taxes; and (e) collection of overdue taxes through computer-generated notices and field operations.

IRS has two main nonfiler programs. The first identifies "stopfilers"—those who had filed returns for a prior tax period, but not for the one tested. The second identifies delinquent nonfilers through matches of third-party information documents with IRS masterfile records of current-year tax return filings. The delinquent returns and taxes are obtained mainly through computer-assisted correspondence, automated paperless operations, or, generally as a last resort, field investigations.

C. How Much of the Net Tax Gap Could IRS Recover?

On its face, the net tax gap appears to be a source of additional federal revenue that could be realized without raising taxes. A significant portion of the net tax gap *could* be collected with a balanced strategy that incorporates expanded and improved IRS programs (including taxpayer service, education, enforcement, and systems modernization), as well as compliance-oriented tax law changes (intended, for example, to reduce complexity and eliminate various opportunities for noncompliance). It is important to realize that IRS enforcement *alone* is neither a cost-effective nor a socially acceptable method of collecting the net tax gap. We do not know how much *can* be collected through enforcement, but the nature of the noncompliance reflected in the tax gap estimates suggests that the potential net revenue gains from enforcement alone are limited; the key is to pursue a balanced strategy. The following sections contain a discussion of the nature of income tax noncompliance and of the difficulties in trying to estimate the maximum portion of the net tax gap that *could* be collected through additional enforcement activity.

The Nature of Noncompliance

The gross tax gap consists of some types of noncompliance (e.g., overstated deductions) that are much easier to detect than others (e.g., unreported income that is not covered by third-party information returns). In fact, almost *half* of the gross tax gap estimate for TY 1987 among filers of individual income tax returns is associated with types of unreported income that are very difficult to detect. These include income not reported by "informal suppliers" (proprietors who operate with informal business styles, usually on a cash basis), other non-farm proprietors (who may keep two sets of "books"), farmers (who may understate cash income received for their produce), and skilled and professional workers (some of whom "moonlight" on a cash basis).[9] Although we have a reasonable basis for *estimating* the total extent of such noncompliance (at least for individuals), it is very time-consuming and costly to *detect* it on a case-by-case basis.

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[9] This is not to say that *all* of the tax gap among these taxpayers is not detectable. These are just some examples of the hard-to-find types of noncompliance among individuals. We estimate what is not detectable by multiplying the amount that *is* detected (without the help of third-party information documents) by a factor

It is also difficult to collect some of what *can* be detected. Although most taxpayers who are found to owe additional tax, penalties, and interest pay their assessments fairly quickly in response to an IRS notice or two, some accounts are never fully collected—especially if the taxpayers are unable to pay.

Moreover, much of the remaining noncompliance occurs in small amounts, spread over a large number of taxpayers. Since our return selection systems are not perfect, we would have to audit *all* returns in order to detect the maximum amount of noncompliance possible. And, since enforcement costs are significant, most of these detectable amounts are not cost-effective to pursue with existing enforcement programs—either to detect or to collect if they *are* detected.

A significant portion of the net tax gap *could* be collected with a balanced strategy designed to foster increased voluntary compliance (through improved taxpayer service, enhanced taxpayer education, expanded enforcement, systems modernization, and tax law changes) and to collect directly the revenue generated by the expanded enforcement. Nonetheless, the net tax gap should not be viewed as a large bank account with which to balance the budget.

Difficulties in Estimating Maximum Cost-Effective Enforcement Yields

Current IRS enforcement programs operate at very favorable yield-to-cost ratios—even at the margin. An expansion of most programs would result in eventual collections amounting to at least four or five times the total cost of the expansion. It is clear that IRS would have to expand enforcement programs dramatically before the marginal cost exceeded the marginal revenue. While this assures us that IRS could cost-effectively recover much of the net tax gap, it also makes it very difficult to estimate just *how much*. Since a large expansion would put IRS enforcement levels well beyond current operational levels, we have little information upon which to estimate the likely revenues and costs at those levels. Research is under way to improve our estimates of the maximum amount that can be recovered cost-effectively, but for now, even our best guesses would have numerous weaknesses. The most important of these weaknesses are discussed below:

1. Unknown indirect effects: It is generally thought that, in addition to the *direct* revenue gains that arise from IRS enforcement, enforcement activities also improve voluntary compliance *indirectly* through deterrence. If so, then significant expansions of enforcement programs would generate corresponding increases in revenues paid voluntarily in subsequent years—both by those contacted by the enforcement activities and by others who learn of the expanded enforcement. This is an area of research receiving increasing attention, but there is still no consensus as to the magnitude of

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derived from a special study. Refer to our 1988 gross tax gap report (Publications 7285 and 1415).

these indirect effects. Estimates (outside IRS) have ranged from roughly the same magnitude as the direct revenue effects to as much as seven times this magnitude. For example, these estimates imply that if an expansion in IRS enforcement activity produced $100 million of revenue directly from the taxpayers contacted, it would also indirectly induce *other* taxpayers to pay an *additional* $100 million to $700 million voluntarily. Although we should include indirect revenues in the yields we expect from any expansion, we are unable to do so with any confidence.

2. Unknown taxpayer costs: When IRS contacts a taxpayer through one of its enforcement programs, such as by auditing his or her tax return, the taxpayer bears some unavoidable costs. The taxpayer must take the time to assemble records, attend interviews, etc. Sometimes taxpayers elect to pay for professional assistance in dealing with IRS enquiries. Currently we cannot estimate the magnitude of these inconveniences and out-of-pocket outlays; ideally they should be included in the costs of any expansion. (In any revenue estimates we might make, we would also need to account for those cases in which some of these expenses would be deductible in calculating taxable income.)

3. Uncertain estimates for large corporations: It is probable that significant additional amounts of tax deficiency could be identified cost-effectively by examining the complex returns of large corporations in greater depth.[10] It is also likely that the amount collected could be increased by improving the quality of the examination-appeals-litigation process so that we assess a larger fraction of the tax deficiency that is proposed. However, we currently have no data with which to make estimates of the maximum cost-effective potential of these two types of improvements. We have initiated projects that may help us make such estimates, but the results of these studies are not yet available.

4. Speculative nature of yield curves: Even for individuals and small corporations, for which we could estimate marginal yield curves based on data from the Taxpayer Compliance Measurement Program (TCMP)[11] and operational data, we could not currently have a high level of confidence in estimates based on them because any such curves would be highly speculative at coverage levels significantly beyond operational levels. There are several reasons for this: TCMP results do not reflect what could or would be recommended by operational examinations; we cannot adequately sort the TCMP cases to reflect the order in which returns would be examined in operational practice; and even the most recent TCMP results are always several years old—not able to reflect completely the impact of changes in law and in taxpayer behavior. (The yield curves used for resource allocation are not as susceptible to these problems, since operational levels do not vary much from year to year.)

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[10] Note that since we lack a reasonable way to estimate how much *more* tax deficiency could be found among large corporations, our large corporation gross tax gap estimates only include the amount detected in our operational programs. When our special projects to quantify this additional gap are completed, we will adjust our gross tax gap estimates accordingly. (All of this additional gap may not be cost-effective to recover, however.)

[11] See Chapter III for an explanation of TCMP.

5. Unknown impact of improved productivity: We currently have little information upon which to estimate how much the productivity of the enforcement functions can be improved—measured either in terms of the ratio of yield to cost or in terms of the percentage of the tax gap that is detected, assessed, and collected. We could estimate the revenue impact of expanding existing programs at the margin assuming no change in the relative productivities of the enforcement functions, but we cannot reliably estimate the maximum revenue impact of improving the *quality* of our enforcement efforts—even at present coverage levels. Improving quality—collecting more of the tax gap with existing resources—might include increasing the cost-effectiveness of enforcement personnel and/or changing the allocation of resources between the various functions involved in the enforcement process (e.g., Examination, Appeals, Tax Litigation and Collection). Several new efforts have been suggested—with some now reaching the implementation stage—that will yield more in revenue than they cost, but we cannot estimate the potential revenue that other (as yet unknown) efforts might realize.

6. Transitional effects: Even if the government *did* want to maximize the net revenue gains arising from enforcement, it could not expand IRS enforcement to these levels in one step. It would probably be very difficult to hire that many new agents at once, and it would take a significant amount of time to train them once they were hired. Instead, the expansion would occur gradually over a number of years. Each step in the expansion would be supported by specific estimates (much more accurate than any we could make of the maximum cost-effective amount) of the net revenue that would be generated by that step alone. As the gradual expansion took place, valuable information would be gained about the amounts of revenue actually obtained from the additional effort, and about the actual cost of the effort. Moreover, from a budget standpoint, any major expansion would incur significant transitional costs—such as the direct cost of training new personnel, the lower productivity of these new people during their first several years, and the forgone revenues associated with assigning experienced agents to train and coach them.

Difficulties in Estimating Compliance Gains From Improved Customer Service Programs

Experience suggests that IRS customer service activities have a positive impact on voluntary compliance. To the extent that IRS can help taxpayers to reduce errors and minimize the frustrations many experience trying to get help, we might realize significant direct—and, perhaps, indirect—revenues. However, we are not yet able to quantify the extent to which the net tax gap can be reduced by improving or expanding our current efforts in this area.

Conclusions

Two major conclusions can be drawn from this discussion:

- A significant portion of the net tax gap (plus amounts of interest and penalties of roughly the same magnitude as the tax collected) *could* be recovered cost-effectively by expanding IRS enforcement efforts; and yet

- The greatest challenge for closing the net tax gap lies in the potential for improving voluntary compliance—by expanding and improving taxpayer service and education programs, by changing the tax law to reduce complexity and to eliminate opportunities for noncompliance, and by modernizing our systems.

Both of these areas are topics of on-going research. As for expanding IRS enforcement efforts, projects are under way that would identify ways to improve the cost-effectiveness of resource allocations to the various enforcement programs, and other studies are proceeding that should improve our ability to estimate the maximum potential of expanded enforcement. As for increasing voluntary compliance, we are developing ways to improve and enhance taxpayer service and taxpayer education programs (although estimating the revenue impact of such improvements may not be possible), and we are studying the indirect effects of enforcement. These research projects will not only aid us in making estimates for future tax gap reports, but—more importantly—will guide IRS efforts directed at closing the net tax gap.

II. The Net Tax Gap Estimates

We have estimated the net legal-sector income tax gap for Tax Years 1981, 1984, and 1987. Table 2 presents detailed estimates for TY 1987, together with less-detailed estimates for TY 1981 and TY 1984. Our higher estimate of the net tax gap increased from $60.7 billion in 1981 to $72.3 billion in 1987, while our lower estimate increased from $53.4 billion to $60.7 billion in the same period. This increase (which, for the higher estimate amounted to $11.6 billion, or 19.1 percent), does not reflect a decline in compliance; indeed, we estimate that the voluntary compliance rate *rose* slightly over this period (see Table 1). Instead, the increase arose from the increase in tax liabilities during the period. Moreover, the enforcement figures in Table 2 suggest that IRS is recovering an increasing share of the gross tax gap through its various enforcement programs—from 20.2 percent of the higher estimate for 1981 to 23.2 percent of the corresponding estimate for 1987. The sections below discuss the estimates for the individual income tax and the corporate income tax separately, followed by a discussion of the trends in the estimates.

A. Individual Income Tax

For TY 1987, our estimates of the gross legal-sector income tax gap for individuals range from $69.1 billion to $71.4 billion. The portion of this which will eventually be collected through IRS enforcement programs (operated at currently anticipated levels) is estimated to be $13.6 billion. Our estimates of the net tax gap for individuals, therefore, range from $55.5 billion to $57.8 billion, as shown in Table 2. (See Chapter III for a discussion of the relative merits of the higher and lower estimates.)

Table 2 presents some detail on the sources of enforcement revenue for the individual income tax. Examination of tax returns and collection of the remittance gap are the largest sources. For 1987, out of the total estimated enforcement tax yield of $13.6 billion in individual income tax, we expect the examination of returns and the collection of the remittance gap (including both insufficient remittance of income tax by individuals and underdeposit of withheld income tax by employers) to account for $4.7 billion each. Matching of third-party information documents (mainly Forms W-2 or 1099) with tax returns or with the IRS individual masterfile is the next-largest element of enforcement revenue.[12] IRS document matching programs for filers and nonfilers combined will recover an estimated $2.3 billion of unreported 1987 tax liabilities.[13] Correction of taxpayer math errors is expected to recover another $1.0 billion of net additional revenue.[14] Finally, delinquency investigations of those who stop filing returns will yield an estimated $0.7 billion in tax revenue.

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[12] Matches with the masterfile identify individuals who had not filed tax returns even though they received significant amounts of income.

[13] This estimate takes into account significant budget cuts that reduced the number of TY 1987 cases worked.

[14] This is an estimate based on prior years. Preliminary data for 1987 suggest that the net amount collected by the math-error program was actually negative for TY 1987, meaning that taxpayers made larger errors in the government's favor than in their own. If this implication is borne out by further analysis—for example, of the impact of the Tax Reform Act of 1986 and of certain administrative changes—then we will revise the tax gap estimates accordingly in our next report.

Table 2. Range of Estimates of the Net Legal-Sector Income Tax Gap[1] (in $ billions), Tax Years 1987, 1984, and 1981

	(1) Gross income tax reporting gap	(2) Remittance gap	(3) Gross income tax gap (1) + (2)	(4) Enforcement yield (tax only)	(5) Net income tax gap (3) - (4)
Tax Year 1987					
Total	73.2 *to* 84.9	9.3	82.5 *to* 94.2	21.9	60.7 *to* 72.3
Individual Income Tax	61.2 *to* 63.5	7.9	69.1 *to* 71.4	13.6	55.5 *to* 57.8
• *Filers*	54.0 56.3	5.0	59.0 61.3	9.9	47.2 49.5
Examination of returns				4.7	
Document matching				1.2	
Correction of math errors				1.0	
Other computer-based adjustments				0.2	
Insufficient remittance				2.8	
• *Nonfilers*	7.2		7.2	1.8	5.4
Stopfilers				0.7	
Document matching				1.1	
• *Employer underdeposit of withheld income tax*		2.9	2.9	1.9	1.0
Corporate Income Tax	12.0 *to* 21.4	1.4	13.4 *to* 22.8	8.3	5.2 *to* 14.5
• Small	4.8 5.2	0.2	5.0 5.4	1.6	3.4 3.8
• Mid-size	0.7 1.6	0.9	1.6 2.5	0.5	1.1 1.9
• Large	6.4 14.3	0.0	6.4 14.3	6.0	0.3 8.2
• Fiduciaries and UBIT[2]	0.2 0.3	0.3	0.5 0.6	0.1	0.4 0.5
Tax Year 1984					
Total	72.7 *to* 81.0	10.3	83.0 *to* 91.3	18.9	64.2 *to* 72.4
Individual Income Tax	64.2 66.4	9.3	73.5 75.7	13.0	60.5 62.7
Corporate Income Tax	8.6 14.6	1.0	9.6 15.6	5.9	3.7 9.7
Tax Year 1981					
Total	59.7 *to* 66.9	9.2	68.9 *to* 76.1	15.4	53.4 *to* 60.7
Individual Income Tax	51.8 53.6	8.3	60.1 61.9	10.7	49.4 51.3
Corporate Income Tax	7.9 13.3	0.8	8.7 14.1	4.7	4.0 9.5

Some components do not add due to rounding.

[1] The results of examinations of tax returns are used in estimating several parts of the tax gap. Where these results are used, the higher estimates of the tax gap are based on the amounts of additional tax recommended by IRS examiners, and the lower estimates are based on the amounts of tax ultimately assessed after all appeals and litigation. If we have correctly estimated the extent to which examiners cannot detect all tax deficiencies, then the "true" tax gaps lie between these two sets of estimates. See Chapter III for a discussion of the two sets of estimates.

[2] UBIT is unrelated business income tax of tax-exempt organizations.

B. Corporate Income Tax

Our estimates of the TY 1987 gross legal-sector income tax gap for corporations range from $13.4 billion to $22.8 billion. Of this, an estimated $8.3 billion will eventually be collected as a result of IRS enforcement. Our estimates of the net corporate income tax gap, therefore, range from $5.2 billion to $14.5 billion.

The corporate tax gap estimates are subject to more uncertainty than the estimates for individuals. While the latter are based on special, intensive audits designed to measure taxpayer compliance (under TCMP), the estimates for corporations are based mainly on the results of operational audits (the only exception being the estimates for corporations having assets under $10 million, which are based on TCMP results). Furthermore, the Tax Reform Act of 1986 (TRA) will likely affect the corporate *net* tax gap in two ways—neither of which is fully understood, given the lack of data. IRS estimates of the gross gap assume that the amount of corporate noncompliance will *grow* in proportion to the growth of tax liabilities brought about by TRA. However, the projections of revenue to be recovered from examination of corporation tax returns assume that TRA will *reduce* enforcement yields for a given expenditure of resources. Enforcement yields will be reduced in part because TRA's lower tax rates reduce the tax liability associated with each dollar's worth of unreported taxable income detected by revenue agents. Also, TRA's repeal of the investment tax credit eliminates an item for which each dollar of adjustment by examiners changes tax liability by a full dollar, rather than by just some fraction of a dollar.

C. Trends

Table 2 shows estimates of the gross and net legal-sector income tax gap for tax years 1987, 1984, and 1981. For example, from 1981 to 1987 our higher estimate of the gross tax gap increased by $18.1 billion, or 24 percent. For the same period, the estimate of enforcement tax yield increased by $6.5 billion, or 42 percent. The difference in growth rates reflects the fact that IRS enforcement revenues are growing not only because of the growth of the tax gap, but also because of expansions and improvements in enforcement programs. The corresponding net tax gap estimate grew by $11.6 billion, or only 19 percent, from 1981 to 1987.

Looking separately at the 1981-1984 and 1984-1987 periods, Table 2 indicates that the estimated gross income tax gap increased during both periods—except for the lower estimate, which declined slightly from 1984 to 1987. The estimated net tax gap declined slightly from 1984 to 1987 after increasing substantially from 1981 to 1984. The estimated gross and net tax gaps for individuals both declined from 1984 to 1987. In contrast, the gross and net tax gap estimates for corporations both increased between 1984 and 1987. These increases in the corporation estimates are due largely to the effects of tax reform. As discussed above, TRA tended to increase corporate tax liabilities while simultaneously reducing anticipated yields from audits of corporate tax returns.

III. Sources and Methods

A. Range of Estimates of the Gross Tax Gap

The tax gap is the difference between "true" tax liability and the amount voluntarily paid. Since we are unable to determine "true" tax liability precisely, we provided two sets of estimates of the tax gap in our March 1988 report: "primary" estimates based on the amount of tax adjustments *recommended* by IRS examiners, and "alternate" estimates based on the amount eventually *assessed*, after all appeals and litigation have been completed.[15] The difference between these two estimates is the amount of the original recommendation which is conceded in the administrative appeals process or lost in litigation. In this report we refer to the "primary" estimates as our "higher" estimates, and to the "alternate" estimates as our "lower" estimates.

Results of examinations (audits) of tax returns are the fundamental data for major parts of our gross tax gap estimates. For individuals and small corporations (those with less than $10 million in assets), the examinations upon which our estimates are based are special audits conducted under TCMP.[16] For larger corporations, the examinations are the regular operational audits of the tax returns of these corporations.[17] At the conclusion of each audit, the tax deficiency "recommended" by the examiner is recorded—on a special checksheet in the case of TCMP audits, and in the Audit Information Management System (AIMS) in the case of regular audits. Unfortunately, neither data source includes information on the amounts eventually assessed on these audits; we have had to rely on other data to estimate these amounts. Moreover, the "alternate" estimates of the gross tax gap in our 1988 report were based on statistics which have since been found to be incorrect. The corresponding estimates reported here have been revised to reflect more reliable information. In this section, we describe the theoretical basis for these lower estimates, discuss the relative merits of the lower and higher estimates, and briefly describe the previous and current sources and methods for the estimates.

The theoretical attraction of the lower estimates is that, in many cases, the final assessment arising from the examination may better reflect the "true" tax liability than does the initial examination recommendation. This may be so because, first, the appeals/litigation process may be considered a review of the examiners' work, so that some errors may be eliminated; and second, the eventual assessment may be considered to be the true *legal* liability in the sense that IRS cannot attempt to assess more later, except in unusual cases.

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[15] These two sets of estimates of the tax gap should not be interpreted as two *concepts* of the tax gap. Since there is only one "true" liability, and a definite amount is voluntarily paid, then there is only one "true" tax gap amount. We provide two sets of estimates only because of uncertainty concerning the "true" liability, which—if our assumptions concerning the detectability of tax deficiencies are correct—is probably somewhere between our two estimates.

[16] Under TCMP, IRS completes thorough, line-by-line examinations of several different types of tax returns. For each type of return, IRS examines a probability sample taken from the entire population, allowing us to make population estimates dealing with a wide variety of compliance issues. To compensate for the fact that even TCMP examinations cannot detect all unreported income, we multiply the amount that *is* detected (without the help of third-party information documents) by a factor derived from a special study. Refer to our 1988 gross tax gap report (Publications 7285 and 1415) for more details.

[17] Our gross tax gap estimates for these corporations account for the fact that not all large corporate returns are examined. However, we assume (for lack of data) that operational audits of large corporations' returns detect *all* tax deficiencies. That is, we "multiply" the amount that is detected by a factor of 1.0. (See the preceding footnote.)

The lower estimates of the tax gap may seem most appropriate in the case of large corporations since more than 90 percent of recommendations from operational examinations are appealed by these taxpayers. Even here, however, it is not obvious that the entire amount conceded or lost should be removed from the estimates of the gross tax gap. There are various reasons for these concessions. For example, appeals officers sometimes simply make mistakes in conceding examination recommendations. In this case, the "true" liability is the original recommendation—supporting the higher estimates of the tax gap. Examiners also make mistakes[18] sometimes—proposing too much additional tax—but there are several categories of reasons for concessions in the appeals/litigation process which fall between these clear polar extremes, making it difficult to estimate where the "true" tax liability lies. In addition to the uncertainty concerning what portion of unassessed recommendations represent "true" tax deficiencies, it is possible that even the *higher* estimates may understate the tax gap for large corporations. Since the examinations of large corporations are not necessarily thorough in pursuing all potential issues on these complex returns, substantial amounts of tax deficiency may not be recommended by the examiners and, hence, may never be included in either the higher or the lower estimates.

For the individual and small corporate tax gap estimates, there are additional complications. TCMP examinations, upon which these estimates are based, are controlled as part of major research projects, in which the principal purpose of finding the the proper tax liabilities of the examined taxpayers is augmented by the purpose of estimating the total tax liability of all taxpayers combined. TCMP examiners are specially trained to be exhaustively thorough in finding all noncompliance, whether it reduces the taxpayers' liabilities or increases them. Every examination is subjected to quality review to determine that all relevant probes have been made and that the results are correct. While it is unreasonable to assume that the TCMP checksheets have no errors whatsoever, it is not unreasonable to assume that the errors are symmetrically distributed with an average of zero; that is, that the aggregate estimate of the total tax liability is not biased. If all TCMP cases were reviewed further by—for example—appeals officers, some errors would be found and corrected, but the aggregate amount of noncompliance would, under this assumption, not change significantly, since both positive and negative errors would be corrected. However, in practice, appeals officers review only those TCMP cases which are appealed by taxpayers (representing only about 20 percent of the recommended deficiencies for individuals, and about 30 percent for small corporations). It seems reasonable to assume that taxpayers whose examiners recommended too little additional tax will, in the aggregate, be less likely to appeal the recommended deficiency, and that those whose examiners recommended too much additional tax will be more likely to appeal. If so, then adjusting the overall TCMP estimates for the results of the appeals process would introduce a bias into the tax gap estimates—that is, the lower estimates would understate the true liability of the taxpayers.

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[18] Actually, not all overstatements of the "true" tax liability are mistakes. For example, in some situations, examiners will recommend the "same" tax deficiency against more than one taxpayer, even though it is clear that only one of them owes the tax. This happens because the factual situations make it unclear which of them does owe the tax, and it is tactically wise to recommend it against all taxpayers who might owe it, pending a final determination in the appeals/litigation process. Here, the "true" liability is the amount assessed, and the duplicated recommendation clearly is *not* part of the tax gap.

Because of the uncertainties concerning the implications of the difference between examination recommendations and final assessments, IRS is conducting research projects to illuminate the matter. These projects involve dividing concessions in the appeals process into the various categories of reasons for concession. We have projects for regular operational examinations and for TCMP examinations. Pending the results of these studies, we will publish two sets of estimates of the tax gap, as in this report.

The "alternate" estimates of the gross tax gap in our 1988 report were based on information gathered by the Audit Integrated Reporting System (AIRS). This system tracks each completed examination through to its final disposition (after the appeals/litigation and collection processes have been completed). Our earlier estimates were based on tabulations for examinations completed in FY 1982. After we published those estimates, the 1982 tabulations were found to contain major anomalies. The 1972 tabulations are evidently accurate but, of course, very out of date. Over the past decade the proportion of examination recommendations which taxpayers appeal has risen dramatically. Meanwhile, the proportion of appealed deficiencies which is conceded has remained fairly stable. It is clear, therefore, that the difference between examination recommendations and final assessments has grown significantly since 1972. This situation is described more completely in Publication 1501, *Evaluation of the IRS System of Projecting Enforcement Revenue*. The lower estimates of the reporting gap shown above in Chapters I and II are based on the "interim method" described in that report.

B. Net Tax Gap

Estimating the net tax gap is, in principle, a straightforward process given that the gross tax gap has already been estimated. One simply subtracts from the gross tax gap estimate the tax revenue (associated with the same tax year) that is eventually collected by enforcement activities. However, the available data on enforcement yields are not commensurate in various ways with the gross tax gap estimates. Therefore, the process of estimating the net tax gap involves numerous adjustments to the enforcement yield statistics to get figures that are conceptually comparable to the gross tax gap estimates. These adjustments are discussed below.

IRS management information systems generally report data on enforcement results—proposed adjustments, actual assessments, and actual collections—by *fiscal year* of IRS operation. The tax gap estimates, on the other hand, of necessity relate to the *tax years* in which tax liabilities are incurred. Thus, an important step in estimating the net tax gap is to translate fiscal year enforcement results into the corresponding results by tax year of liability.

Collecting taxes that were not voluntarily paid takes time. The assessments of additional tax IRS makes during a particular fiscal year relate to a number of earlier tax years. Assessments made in FY 1987, for example, related to returns filed for tax years 1986, 1985, 1984, and even earlier—going back to the late 1970s. Reaching agreement with some large corporations on the additional tax due may take longer than 10 years, including time taken in appeals and, in some cases, litigation. In these cases, assessments will fall behind incurred tax liabilities by more than a decade. Consequently, even if the IRS management information systems were to report data by tax year of liability, we would have to wait until the second half of the 1990s to determine enforcement tax yields related to tax years in the late 1980s.

We translate the available data (and projections) on proposed adjustments or assessments of additional tax (by fiscal year of recommendation or assessment) to estimates for the corresponding tax years using typical distributions of the elapsed time between the tax year of liability and the fiscal year of assessment. Revenue collections, in turn, often lag behind assessments. For purposes of tax gap estimation, however, we need not concern ourselves with these lags as long as we have estimates of the proportions of assessments that will eventually be collected. These proportions, which we used to translate assessments to eventual collections, vary by type of revenue-producing enforcement program. For some collection programs, it was possible to derive a combined proportion from a previous study of the individual net tax gap. In other cases, where program-specific data were not available, the proportions were derived from management information systems for the individual income tax. In the case of assessments and collections that eventually arise from examinations, we based our estimates on the "interim method" of estimating examination-related revenue described in Publication 1501.

Another problem is that IRS information systems frequently combine tax yields with associated penalties and interest. To estimate the net tax gap, we must "back out" these penalty and interest amounts. Since interest and penalties are not included in the gross tax gap estimates, including them in the enforcement tax yield would understate the resulting net tax gap estimates.

IV. Remittance Gap

The gross legal-sector income tax gap estimates IRS published in March 1988 consisted of the tax liability reporting gaps of individuals and corporations. The estimates did not include remittance gaps that occur when taxpayers report their tax liabilities, but the full amount is not remitted voluntarily. In the case of the individual income tax, the remittance gap has two main components: (a) insufficient remittance of tax balances due when taxpayers file their returns; and (b) employer underpayment of income taxes they withhold from wages.[19] The latter component is part of the individual income tax remittance gap since it represents income tax obligations which have been reported by individuals but are not paid to the government. In the case of the corporate income tax, only the first type of remittance gap applies.

Table 3 shows that, for TY 1987, the estimated gross remittance gap is $9.3 billion. The largest component of this, an estimated $5.0 billion, is due to insufficient remittances of individual income tax balances due at the time of filing. Estimated employer underpayments of individual income tax withheld amount to $2.9 billion. The corporate income tax remittance gap estimate is the smallest component at $1.4 billion. The total gross remittance gap estimate grows from $3.6 billion in 1973 to $13.3 billion in 1992. This growth and the growth of the net remittance gap were interrupted in 1982 as the economic recession, and the tax rate cuts enacted in 1981, reduced income tax liabilities, and, consequently, taxes due at the time of filing. A second interruption in the growth of the gross and net gap totals was due to the Tax Reform Act of 1986, which lowered these gaps for individuals by more than it raised them for corporations. Nonetheless, when expressed as a percentage of total tax liability reported, the remittance gap declines slightly from 1973 to 1992—from about 2.5 percent to about 2.2 percent of tax voluntarily reported.[20]

The estimates of the gross remittance gap are based on special data extracts from recent IRS masterfiles of individual and business tax records. For the portion due to insufficient remittance of individual income tax balances due, the masterfile data were for TY 1982 and TY 1983. Estimates for those years were extrapolated back to 1973 and forward to 1992 using actual or projected values of total individual income tax due at the time of filing. Actual values of tax due at the time of filing through 1985 came from IRS' Statistics of Income (SOI) program. These values were extrapolated to 1992 using projections of income tax to be reported on individual tax returns. Historically, the average growth rate in the amounts of tax due at the time of filing is very close to the growth rate in total tax liabilities reported by individuals. The estimates of employer underdeposit of withholding are also based on a masterfile analysis for TY 1984 and TY 1985. Withheld income tax is assumed, in this analysis, to have been not voluntarily paid if it was still

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[19] Payers of interest and dividends may also underdeposit some of the tax they are required to withhold under the backup withholding provisions of the Interest and Dividend Tax Compliance Act of 1983. However, we have no data on this element of noncompliance.

[20] These percentages are for the total remittance gap, but the decline was similar for both the individual income tax and the corporate income tax.

Table 3. Legal-Sector Income Tax Remittance Gap Estimates (in $ billions), Selected Tax Years, 1973-1992

	1973	1976	1979	1981	1982	1984	1986	1987	1988	1992
Gross Remittance Gap	3.6	4.8	7.2	9.2	7.9	10.3	10.6	9.3	9.7	13.3
Individual income tax	3.0	4.1	6.4	8.3	7.2	9.3	9.5	7.9	8.3	11.4
Insufficient remittance by individuals	1.9	2.6	4.1	5.2	4.2	5.8	5.3	5.0	5.3	7.5
Employer underdeposit of withheld income tax [1]	1.0	1.5	2.2	3.1	3.0	3.5	4.2	2.9	3.0	3.9
Corporate income tax	0.6	0.7	0.9	0.8	0.7	1.0	1.1	1.4	1.5	2.0
Net Remittance Gap	1.4	1.9	2.8	3.6	3.1	4.0	4.1	3.6	3.8	5.2
Individual income tax	1.2	1.6	2.5	3.3	2.8	3.7	3.7	3.2	3.3	4.5
Insufficient remittance by individuals	0.8	1.1	1.8	2.3	1.8	2.5	2.3	2.2	2.3	3.2
Employer underdeposit of withheld income tax [1]	0.4	0.5	0.8	1.0	1.0	1.2	1.4	1.0	1.0	1.3
Corporate income tax	0.2	0.2	0.3	0.3	0.2	0.3	0.4	0.5	0.5	0.7

Some components do not add due to rounding.

[1] Employers deposit withheld income taxes and social security taxes together. These figures represent only the income tax portion of their underpayments.

overdue one month after the close of the quarter for which the employment tax return was filed. For the corporate remittance gap, the masterfile analysis was for TY 1984 and TY 1985. The estimates for those years were extrapolated with methods similar to those used for individuals.

Each of the components of the net remittance gap was estimated as a constant proportion of the corresponding gross gap. The proportion used to estimate the net gap for insufficient remittances of individual income tax was derived from an analysis of 1982-83 data pertaining to enforcement-related collections. The proportion for employer underdeposits of withheld individual income tax was derived from an analysis of recent accounts receivable data. The ratio of the net to the gross corporation income tax remittance gap was assumed to be equal to the corresponding ratio for employer underdeposit of withheld individual income tax.

Internal Revenue Service

APR 26

TO: Beth Vance
Oversight Subcommittee
1105 Longworth

Beth:

At the April 19th hearing on the tax gap. the Commissioner promised to provide the Subcommittee with copies of the recent study on the Coordinated Examination Program (CEP). I have attached copies of that study as well as copies of the accompanying Chief Counsel review of their CEP efforts.

Gayle

Attachments

Gayle G. Morin
Assistant to the Commissioner
(Legislative Liaison)

CEP - QIP

Proposal for Changes
to
Coordinated Examination Programs

Internal
Revenue
Service

Assistant Commissioner (Examination)
April 9, 1990

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EXECUTIVE SUMMARY

REPORT FROM THE QUALITY IMPROVEMENT TEAM

The Quality Improvement Program (QIP) Team issued its report on the Coordinated Examination Program (CEP) which identified problems in the following areas:

Issue Identification and Case Development.

Low Sustention Rates.

Industry Specialization Program.

Use of Outside Experts.

Support Audits.

Late Taxpayer Responses to Information Document Requests.

Litigation Strategy.

The Lack of Examination Settlement Authority.

Communication and Coordination between Examination, Appeals and Counsel.

The CEP-QIP team recommended a new organization structure to solve these problems. It proposed a CEP Policy Board; a centralized National Office organization with line-authority Directors over Examination, Appeals and Counsel; and 4 area regional managers for each function under the supervision of the respective National Director. Expanded industry specialization, technical support, training and coordination would be provided under the proposed highly centralized organizations.

INPUT FROM INTERESTED PARTIES

Interested parties from within and outside IRS generally concurred that the identified problems were valid; however, there

WAS LITTLE SUPPORT FOR THE CONCLUSION THAT CENTRALIZED CONTROL IN THE NATIONAL OFFICE WOULD ACHIEVE THE PROGRAM IMPROVEMENTS ENVISIONED BY THE CEP-QIP TEAM.

A CHARGE FROM THE BOARD OF DIRECTORS

DISCUSSIONS DURING THE JANUARY 1990 BOARD OF DIRECTORS MEETING LED TO A REQUEST TO DEVELOP A PROPOSAL FOR CHANGES TO CEP, TO BE PREPARED BY EXAMINATION, APPEALS AND COUNSEL.

RECOMMENDATIONS

RECOMMENDATIONS TO ACHIEVE THE NECESSARY PROGRAM IMPROVEMENTS INCLUDE:

- ORGANIZATIONAL CHANGES:
    - NATIONAL POLICY BOARD
    - NATIONAL DIRECTOR, CEP
    - REGIONAL PROGRAM MANAGERS
    - DISTRICT COORDINATORS FOR FUNCTIONAL CONTROL OF INDUSTRY SPECIALIZATION
- BRING TOP MANAGEMENT INTO PLANNING PROCESS AND CONTROL SUPPORT EXAMINATIONS.
- IMPROVE TAXPAYER COOPERATION.
- STRENGTHEN SPECIALIZATION PROGRAM AND ESTABLISH ISSUE EXPERTS.
- COMMUNICATION SYSTEM FOR TECHNICAL AND ISSUE INFORMATION
- CENTRALIZE ADVANCED TRAINING.
- IMPROVE SYSTEMS TO PROVIDE LEGAL AND TECHNICAL ADVICE TO EXAMINATION.
- IMPROVE SUSTENTION RATE AND REDUCE LAPSE TIME ON ISSUES.
- IMPLEMENT AND CARRY OUT A QUALITY IMPROVEMENT PROGRAM ESTABLISHING BASELINES, ACTIONS AND TARGET IMPROVEMENT FACTORS.

COST AND TARGETED BENEFITS

The cost of additional staffing and support items to carry out the recommendations is projected to be approximately $4.6 million for Examination.

Targeted improvements for FY 1991 are to accelerate collection of revenue by $550,000,000.

Specific goals for FY 1992 and beyond are target improvements to yield, timeliness, sustention rates, taxpayer cooperation and other critical success factors. These will be developed with input from IRS and outside customers. During FY 1991, measures on critical factors for program success, baselines and target improvement factors will be adopted.

BACKGROUND

REPORT BY THE QUALITY IMPROVEMENT TEAM

On December 1, 1989, the Quality Improvement Team issued its report on the Coordinated Examination Program.

The QIP team's overall conclusions were that potential tax dollars are lost because issues are not being raised and the sustention rate needs improvement.

The team concluded the Service does not have an effective Industry Specialization Program or coordinated system for identifying issues at the national level; does not effectively deal with coordinating multi-district audits, taxpayer caused delays, or using outside experts for case development; and does not ensure timeliness of examination activities.

The team also found that the Service does not have consistent settlement of industry issues and that little expertise is shared across regional boundaries.

The team also concluded there are no overall litigation strategies for industry issues.

In support of their recommendations, the team noted that "too many people have responsibility for CEP, and accountability is not fixed in a manner which will bring about desired results."

The QIP team's recommendations include the creation of a new organization centralized at the national level, with line authority. CEP national directors would be established for Examination, Appeals and Chief Counsel, along with four area directors for each function. The new organization would provide clear communications, high levels of coordination, expanded industry and issue specialization and technical assistance. Highly centralized management would allow crossing area lines and provide for review and/or approval of positions on industry issues.

The recommendations provide for a National Policy Board comprised of the directors from Examination, Appeals and Counsel. This board would be responsible for program evaluation and accountability, trend identification, litigating strategies, technical guidance and rulings, and coordination of cross-functional training.

INPUT FROM INTERESTED PARTIES

The Regional Commissioners generally agree that the QIP team identified valid problems relating to coordination and issue development. In addition, there is support for revitalizing the CEP and expanding industry and issue specialization. Also, there is substantial agreement with the benefits of establishing a National Policy Board for CEP and strengthening functional management at national and regional levels.

However, there is opposition to a new centralized organization with line authority for CEP. The Regional Commissioners are concerned that adoption of this recommendation will not deal with root causes of the identified problems and will create other significant operational and managerial problems. There also is doubt that the proposed organization is workable in view of the span of control for national and area managers in the three functions. Finally, there is a view that National Office has responsibility for establishing policy and oversight and should not be diverted with line management responsibility for CEP.

The Assistant Regional Commissioners (Examination) are of a single view in opposing line management centralization of CEP and key region concept. There is total support from this group for a National Policy Board for CEP; National and Regional Directors for CEP; increasing the use of specialists; strengthening/creating specialization for industries, issues and sections of the IRC; improving communication between functions; better dissemination of information on issue identification and development; and line authority over controlled issues.

The Regional Counsels also expressed concerns about establishing a centralized national structure to manage CEP. They recommend enhancing coordination throughout the functions, expanding technical and information gathering resources and increasing accountability. They also recommend designating a Counsel attorney to each CEP examination and revising Appeals procedures to increase communications with Examination.

AICPA, TEI and other outside parties did not agree with some of the QIP team's findings and recommendations.

TEI is concerned that the QIP team's proposal will increase litigation. They are also concerned about reported comments relating to taxpayer caused delays in examination.

AICPA GENERALLY AGREES THAT IDENTIFIED ISSUES IN THE QIP REPORT REQUIRE ATTENTION. HOWEVER, THERE IS DISAGREEMENT WITH THE SOLUTION. THEY FEEL THAT CENTRALIZATION WILL NOT DEAL WITH THE PROBLEMS IDENTIFIED IN THE QIP TEAM'S REPORT.

AICPA SUGGESTS THAT THE SERVICE SHOULD IMPROVE COMMUNICATION ABOUT AVAILABLE TECHNICAL RESOURCES IN THE OFFICE OF CHIEF COUNSEL AND MAKE USE OF THIS EXPERTISE.

AICPA MADE SEVERAL RECOMMENDATIONS FOR IMPROVING THE PROGRAM INCLUDING BETTER TRAINING, COMPENSATION AND MANAGEMENT OF EMPLOYEES IN THE PROGRAM. AICPA NOTES THAT INADEQUATE FUNDING IS THE MAJOR PROBLEM WITH THE PROGRAM.

CHARTER TO PREPARE AN EXECUTIVE COMMITTEE PROPOSAL

IN VIEW OF THE QIP TEAM'S RECOMMENDATIONS, THE BOARD OF DIRECTORS DURING THE JANUARY 1990 MEETING REQUESTED THAT THE A/C (EXAMINATION) AND ACTING CHIEF COUNSEL DEVELOP A PROPOSAL FOR CHANGES TO THE COORDINATED EXAMINATION PROGRAM.

THE PROPOSED OBJECTIVES WERE TO IMPROVE PROGRAM EFFICIENCY AND EFFECTIVENESS, THEREBY INCREASING REVENUE TO THE U.S. TREASURY, IMPROVING SUSTENTION RATES, AND INCREASING TIMELINESS (REDUCE LAPSE TIME AND IMPROVE CURRENCY OF EXAMINATION CYCLES).

INFORMATION SOURCES FOR THE PROPOSAL INCLUDE THE QIP TEAM'S REPORT, PRIOR STUDIES OF CEP, AND INPUT FROM PROFESSIONAL ASSOCIATIONS AND INTERESTED PARTIES.

RECOMMENDATIONS

OVERVIEW OF PROPOSAL RECOMMENDATIONS

THE RECOMMENDATIONS TO ACHIEVE THE CHARTER OBJECTIVES OF INCREASED REVENUE TO U.S. TREASURY, IMPROVE SUSTENTION RATES, AND REDUCE LAPSE TIME ARE SUMMARIZED BELOW:

- ESTABLISH A MULTI-FUNCTIONAL NATIONAL POLICY BOARD.
- ESTABLISH A NATIONAL DIRECTOR FOR CEP, AND REGIONAL CEP MANAGERS WITH SUPPORT ORGANIZATIONS.
- BRING TOP MANAGEMENT OFFICIALS INTO THE PLANNING PROCESS AND IMPROVE THE MANNER IN WHICH WE MONITOR AND CONTROL SUPPORT EXAMINATIONS.

- Increase managerial oversight and the use of available procedures to ensure taxpayer cooperation.
- Expand/create industry and issue specialization and establish experts for examination of highly complex issue areas.
- Establish a training program.
- Develop effective communication systems to move technical information to front line examination personnel.
- Establish a program to provide legal and technical assistance to examination personnel on an expedite basis.
- Implement and carry out a quality assurance and quality measurement system using the "peer review" concept.
- Improve sustention rates and reduce lapse time on unagreed cases by early settlement offers and coordination between Examination, Appeals and Counsel.

ORGANIZATION RECOMMENDATION

NATIONAL POLICY BOARD

This board will serve to focus high level executive attention to CEP from a multi-functional perspective. It will establish policy to ensure better coordination between Examination, Appeals and Counsel.

The board will decide policy issues arising from program operations which have cross-functional impact.

The board will promote taxpayer cooperation through periodic meetings with TEI, AICPA, ABA and other interested parties during which issues relating to CEP will be considered.

The board will also review the implementation and accomplishment of recommendations to improve CEP.

Specific activities recommended for the board include the following:

- Establish policy for support and coordination between functions.

- Maintain ongoing liaison with professional and business organizations.

It is recommended that the board consist of the following executives:

Assistant Commissioner (Examination)
Assistant Commissioner (International)
Representatives from Chief Counsel
National Director of Appeals
Regional Commissioner and District Director
(rotational basis)

DIRECTOR, COORDINATED EXAMINATION PROGRAM

CEP is currently under a Section Chief in the Office of Examination Programs, along with industry specialization and computer assisted audits. Eight analysts and 3 team leaders are responsible for CEP, ISP, CAS, economists and engineers program development, oversight and evaluation. The office is responsible for liaison activities, monitoring program accomplishments, dissemination of technical digests, coordination of training, and conducting regional reviews.

To provide the necessary level of program development, oversight and evaluation required for a "managed process," it is recommended that a Director position be established responsible for CEP, industry and issue specialization, experts for examination of complex issue areas, computer assisted audits, economists and engineers. It is also recommended that 2 sections be established to support this office with staffing reflected on Attachment II.

Specific responsibilities of the office are:

- Provide assistance in examination planning to deal with current taxpayer organizational complexities and tax planning.

- ESTABLISH GUIDELINES TO IMPROVE CURRENCY OF AUDIT CYCLES.
- ISSUE DIRECTIVES ON COORDINATION AND CONTROL OF INDUSTRY/TECHNICAL ISSUES.
- ESTABLISH A PROGRAM TO COORDINATE AND CONTROL ADVANCE RULINGS ON TRANSFER PRICING WITHIN EXAMINATION AND TO COORDINATE ACTIVITIES WITH OFFICE OF CHIEF COUNSEL.
- ESTABLISH GUIDELINES FOR COORDINATION WITH APPEALS AND COUNSEL.
- PROVIDE EFFECTIVE OVERSIGHT AND EVALUATION OF THE PROGRAM THROUGH CONTINUING ON-SITE REVIEWS OF REGIONS' MANAGEMENT OF CEP AND SPECIALIZATION OF INDUSTRY AND TECHNICAL ISSUES.
- IDENTIFY INDUSTRIES AND ISSUES FOR COORDINATION BY ESTABLISHING SYSTEMS FOR GATHERING AND ANALYZING INFORMATION FROM FIELD OPERATIONS AND GOVERNMENTAL, BUSINESS, INDUSTRY AND PROFESSIONAL GROUPS.
- DEVELOP AUDIT TECHNIQUE GUIDELINES FOR INDUSTRIES.
- DEVELOP TRAINING MATERIALS AND DELIVERY SYSTEMS FOR CASE AND SPECIALTY MANAGERS, CEP EXAMINERS, AND SPECIALISTS ON A CROSS-FUNCTIONAL BASIS WITH APPEALS AND COUNSEL.
- DEVELOP COMMUNICATION SYSTEMS TO MOVE INFORMATION BETWEEN CEP MANAGERS AND EXAMINERS AND REGIONAL AND NATIONAL OFFICE MANAGERS.
- DEVELOP WITH CHIEF COUNSEL A PROGRAM TO PROVIDE TECHNICAL AND LEGAL ASSISTANCE TO EXAMINATION PERSONNEL.
- CARRY OUT DIRECTIVES OF THE NATIONAL POLICY BOARD.

REGIONAL CEP MANAGER

IT IS RECOMMENDED THAT A REGIONAL CEP MANAGER BE ESTABLISHED, ALONG WITH AN ISP MANAGER, AT THE REGION'S OPTION, WHO WILL HAVE LINE AUTHORITY OVER INDUSTRY/ISSUE SPECIALISTS. WHERE INDUSTRY/ISSUE SPECIALISTS ARE SUPERVISED AT THE DISTRICT LEVEL, THE REGION WILL PROVIDE FUNCTIONAL OVERSIGHT TO ENSURE PROGRAM EFFECTIVENESS.

The Regional CEP manager will increase functional oversight of District CEP, provide for line/functional supervision of industry and issue specialization and experts for examination of complex areas, manage a communication system for technical information, and improve management and accountability of district managers responsible for CEP.

The Regional CEP manager will supervise managers/analysts assigned responsibility for CEP, ISP, CAAP, International, Engineering and Economist programs. Functional management will be provided to a new position (District ISP coordinator) responsible for technical coordination of ISP issues.

The role of the Industry Specialist needs to be readdressed. Studying and monitoring current industry practices must be an ongoing process in order to identify potential issues. There needs to be significant improvement in cross-coordination among ISPs to share experiences on overlapping problems and issues. This can be accomplished by strengthening the line of communication between regional offices and the National Office.

The Regional CEP manager and CEP/ISP analysts will also be responsible for ensuring an adequate communication network for the ISP program in CEP and non-CEP cases at the district level, through the functional support of the District ISP Technical Coordinators.

DISTRICT CEP MANAGEMENT

It is recommended that the following changes be made to District Office operations:

- Line authority for ISPs be transferred to the Regional Office (at the region's option).
- Districts establish an ISP technical coordinator position.

The proposal will implement a management system that elevates the responsibility of the Industry Issue Specialist from a District branch chief to an Assistant Regional Commissioner (Examination). Accountability will be elevated to a level of management that has control over resources and funding that is not available to the district. Communications will be improved by moving the ISP to the Regional office. At the regional office, the ISP Coordinator will serve as a liaison between the National office and the District offices to increase communication.

With the potential for significant growth in both the Industry and Issue Specialist programs and with line authority over the ISPs shifted to the regional office, there is a need for a District ISP Coordinator in every district. It is envisioned that in most districts this will be a part-time responsibility and in some of the major districts a full time occupation. The coordinator will work with management to ensure that the ISP issues are properly planned and developed in both CEP and non-CEP cases. The coordinator will, on multi-industrial issue taxpayers and on non-CEP cases, assist the managers in securing the help of the appropriate ISPs. The coordinator will serve as a liaison between the district and regional offices. Communication will be enhanced as potential issues, concerns, problems, auditing techniques are elevated to or from the regional offices. The coordinator will establish a network between the regional and district offices. The District ISP coordinator serves as a pipeline between the examiner and the regional office.

EXAMINATION PLANNING PROCESS

Concerns have been expressed within the Service and by some professional organizations about the examination planning process. While it is difficult to measure the extent of this problem, it is recognized that improvements are necessary.

Effective and timely examination planning is vital to quality examinations in CEP. Consideration must be given during the planning process to economic, business and industry trends relating to the CEP taxpayer. Industry and technical coordinated issues must be considered and specialty managers must be responsible and accountable for planning related to international, engineering, economist, employment, excise and computer-assisted audit aspects of examinations.

Risk analysis must be the focus of examination planning. Detailed financial statement analysis needs to be done, giving significant attention to statement changes between fiscal periods. Statement footnotes must be carefully analyzed to ensure that changes to terminology and reporting methods between accounting periods are clearly understood. Mergers, acquisitions and reorganizations should be carefully analyzed for tax planning areas and controlled foreign subsidiaries should be considered for examination since international activities provide unusual opportunities for aggressive tax planning positions.

A substantial responsibility of the National Director, CEP will be to support case examination planning by providing technical issue and tax planning information. This information will be developed from sources within IRS, treaty partners and professional seminars and lectures.

There is potential for improved examination planning through the development of expert systems. These systems share the expertise of the best technicians and provide for analysis on a consistent, error-free basis. The A/C (International) and Research Division developed an expert system for Section 482 examination planning. This system is being piloted in Southwest Region. The Director, CEP will identify additional areas for expert system development.

It is recommended that expectations be established for District Director and Examination Division Chief involvement in planning examinations of appropriate CEP taxpayers. While it is recognized that Directors and Division Chiefs in larger districts can not attend all planning activities, this should be an area of high level managerial involvement. This is warranted in view of the resource allocation to this program and the yield resulting from these examinations. Additionally, it is recommended that the District Director and Division Chief participate in selected post-examination management critique. This will enable them to address problems encountered during the examination and raise critical areas of concern for resolution.

It is also recommended that the ARC (Examination) and Regional CEP manager on a sample basis regularly attend planning and post-examination critiques to provide oversight in this critical area of the examination process.

SUPPORT AUDITS

Support audit is an area which can be improved through better functional and line management.

Procedures for obtaining support audits need improvements. A peer review study showed that support audit requests were submitted timely in only 67% of involved cases. Case managers did not request support audits because of concerns that inexperienced personnel would be assigned to do support work. In other cases, requested support audits were not accepted by the support districts. This resulted in support work not being done or being inadequately done by the primary district.

It is proposed that support audits must be requested in accordance with existing IRM procedures and the examination conducted by the support district with trained and experienced personnel. Exceptions will require the approvals of the ARC's (Exam) of the key and support regions.

During post-examination management critiques, the District should review support requests sent and received to ensure compliance with support requests guidelines. Problem areas should be brought to the attention of the ARC (Examination) for resolution.

It will be the districts' responsibility to request adequate staffing to honor the support requests and to apply their CEP resources accordingly. The Regional CEP Manager will monitor the staff year allocation and ensure that CEP personnel are assigned to support examinations. Support examinations will be subject to peer reviews to ensure the quality of work.

Accountability will be improved under this proposal since District Directors, Division Chief and the ARC (Exam) have the responsibility to ensure that quality support examinations are conducted in a timely manner. Through adequate resource allocations for support work and program oversight, the ARC (Exam) will ensure an effective support audit program.

PROMOTING TAXPAYER COOPERATION

The CEP-QIP team found that the Service does not use all available tools to expedite case closures. In a recent internal review of closed CEP cases, it was determined that meetings were held between the case manager and the tax department to address delays in responding to information document requests on 86 percent of the cases surveyed. On 45 percent of the cases, summonses were considered to secure the requested information. However, summonses were issued on only 4 percent of these cases.

The professional community is concerned that the lack of currency in some examinations is a contributing factor in the Service's difficulties in obtaining necessary documentation.

The Service should meet with representatives of various taxpayer organizations to work on the means for improving currency, i.e., timeliness of examinations. In addition, Currency is a critical area for quality improvement and Examination personnel should be involved with establishing baselines, improvement activities, and target improvement factors.

Case managers and examiners must also be encouraged to use all the tools available to them to improve compliance with document requests. The District Counsel Attorney designated for the case can be instrumental in dealing with problems which hinder the development of the case. The attorney can assist the Service in getting the information it needs to develop an issue and can help in drafting a summons and Section 982 requests. Management must be prepared to issue summonses and 982 letters at the earliest time it becomes apparent that the taxpayer is not providing information on a timely basis. The Division Chief and District Director should be personally involved in all situations where requests for information are not adhered to in a reasonable manner. The Assistant Regional Commissioner (Examination) will consider district management involvement in encouraging compliance with Information Document Requests when conducting a Regional Operational review.

In addition, it is recommended that consideration be given to revising IRM 4024 dealing with accountant's tax accrual workpapers. IRM 4024 should be discussed with interested parties from within and outside the Service prior to revision to ensure adequate consideration of all viewpoints.

Increased functional and line manager involvement with CEP is the key to significant improvements to CEP. Front line personnel must be provided with training, legal and technical support. The case manager must be the on-site technical leader. However, there also must be top level management support and involvement to bring accountability to this process. When needed, the District Director will meet with the Chief Operating Officer during the examination to discuss progress. This meeting will also promote effective case management on the part of Service personnel.

This high level managerial involvement will also provide a means for information with policy implications to be brought to the attention of the National Policy Board.

STRENGTHEN SPECIALIZATION PROGRAM AND ESTABLISH ISSUE EXPERTS

The current specialization program needs improvement. Control, coordination and accountability are inadequate to ensure consistent treatment of industry issues.

Discussions with outside interested parties lead to the conclusion that the complexity of business operations requires specialized knowledge of an industry for effective auditing. Accounting firms have organized around industries with full time directors responsible for respective industries. Responsible individuals are designated for specialized issues who ensure that technical positions are clearly communicated and who develop and teach the relevant subject technical matter.

These industry groups are, in some accounting firms, supported by a national tax office with responsibility to provide technical support. The clients of the national tax office are the industry groups within the firm. The national tax offices are staffed with tax experts responsible for specific sections of the Code. These experts are accountable for developing and teaching their assigned subject matter.

Recommendations to improve specialization include the following:

- Expand industry areas for specialization.
- Establish program for specialization of technical issues that cross industries.
- Expand controlled issues where unique industries require centralized control on issues.
- Establish technical examination experts for a limited number of highly complex areas.

Through the management changes recommended above and through better communications, areas requiring specialization will be identified. District ISP Coordinators and Regional ISP managers will be responsible for promoting and coordinating the identification of issues and industries for specialization.

In addition to identifying areas for specialization from within the Service, information should be requested from the public accounting firms on how industry organization is handled and what technical areas are specialized.

In view of the high complexity involved with mergers and acquisitions, new financial products, commodities, petroleum, transfer pricing, foreign tax credit and inventories, it is recommended that specialization be expanded to cover issue areas that cross multi-industries. This added degree of specialization will provide for coverage of areas not handled well in the normal industry specialization programs. It will also concentrate technical and auditing activities to provide for development of Service positions and for consistent treatment.

It is also recommended that the concept of "controlled issues," along the lines of petroleum in Southwest Region, be retained and expanded to areas where the size, uniqueness or importance of the issues require an added element of centralization and control.

Additionally, it is recommended that a limited number of technical expert positions be established to handle areas requiring highly specialized knowledge. Foreign tax credit is an example of an area that requires such specialization to help plan examinations, to conduct examinations for large difficult returns, and to identify areas requiring the establishment of Service technical positions.

IMPROVE COMMUNICATION SYSTEM FOR TECHNICAL, INDUSTRY AND ISSUE INFORMATION

The CEP-QIP report recognized problems relating to communications which reduced the effectiveness of the ISP and examination planning. Audit Techniques Handbooks need to be updated for industries under the ISP and the current ISP Digest needs improvement to effectively communicate technical information on a broad base to all employees in CEP.

It is proposed that an electronic bulletin board system be established to handle the dissemination of technical information. It is also recommended that CEP functional managers carry out a program to establish current technical manuals for auditing specialized industries and issues.

ISSUE TRACKING

It is also proposed that significant issues be tracked on a limited basis.

Appeals maintains a system to follow the disposition of all work units with disputed amounts of $1 million or more. For those work units of $1 million to less than $10 million, the top five issues greater than $100,000 are traced. For work units of $10 million or more, the top 10 issues greater than $100,000 are traced. The system allows Appeals to analyze issues by frequency of issue (by Code section) or by largest dollar amount (proposed adjustment). On the issues tracked, the report indicates the Code section involved, description of the issue, and the adjustments proposed by Examination, Appeals, and Counsel. The information is updated quarterly. The analysis helps Appeals in identifying trends, and in selecting areas where they should increase training.

Since Appeals has a system in place, Examination should review the Appeals Issue Tracking System to determine whether we can use it to measure issue potential. The information contained in the Issue Tracking System should be disseminated to ISP coordinators in each District who will be responsible for interpreting, evaluating and disseminating this information. In addition, consideration should be given to the "Uniform Issue List" used by Chief Counsel for indexing issue areas under Code sections.

CENTRALIZE ADVANCED TRAINING

The Service's training program for advanced technical subject matter needs improvement to equip CEP personnel to do the job.

It is proposed that a program be established to provide advanced training for senior examiners and managers (including all specialists) in a university setting with subject matter being developed and taught by outside instructors.

TEI has offered to work with the Service to conduct business training. Other outside professionals recommended the following:

> The Service should look to the academic community for assistance in developing and presenting advanced technical training in law and business concepts since this community is willing to help IRS. This training program could be established under an umbrella consortium with a key university managing the program. Professors could be pulled from other universities to develop and instruct key courses.

The Service has some limited experience with university conducted training. Examination has a program with North Texas State to train computer audit specialists and Chief Counsel has a program with New York University.

The following is recommended in considering this proposal:

- The National Office, Examination function, will have control of training funds for CEP and specialty program training.
- The CEP Training Coordinator will control the timing of training to maximize benefits.
- The Service should fund outside training for specialty areas.
- The Service should establish cross-functional training for Examination, Appeals and Counsel.
- The Service should solicit input from professional organizations in the development and revision of our training course materials.

PROVIDE LEGAL AND TECHNICAL ADVICE TO EXAMINATION ON A TIMELY BASIS

In some cases, National Office attorneys with specialized issue expertise are called on for assistance in developing technical issues. Counsel will designate specific attorneys to assist CEP personnel upon request. Practices vary widely from region to region and within regions.

It is proposed that a Counsel attorney be designated at the start of each CEP examination as the principal legal advisor to the CEP examination team. This proposal is intended to serve a number of purposes:

- The attorney may assist Examination by facilitating the obtaining of information through assertive use of summons and Section 982 procedures.
- The attorney may assist in getting technical assistance from National Office attorneys with specialized expertise.
- The attorney may provide advice in the development of legal theories and facts in support of proposed adjustments, or point out flaws in factual development during case processing.

- The attorney may litigate, if necessary, the issues raised in the examination, with a full familiarity of the taxpayer, the facts and the legal position of the Service on the issues.

The designation of a Counsel attorney to the audit will facilitate timely securing of information necessary to complete the examination. In addition, documents that Counsel deems vital to the development of the issue can be obtained and the coordinated efforts of Examination and Counsel will better focus the efforts of the taxpayer to provide only relevant documents.

The Counsel attorney may also be instrumental in Examination and Appeals' resolution of an issue in a prior cycle. This analysis may improve factual development of the issue in a subsequent cycle in Examination.

The Counsel attorney may be responsible for locating technical tax expertise in the National Office and coordinating the hiring of outside experts.

These recommendations to improve legal support do not change Examination's responsibility for conducting and controlling the examination. Examination will continue to make the decisions on issues arising during the examination.

The Service has a highly trained legal staff in Technical, International and Litigation (Chief Counsel). These attorneys could function like a national tax office of accounting firms by providing technical assistance to CEP examiners on an expedite basis.

Because of concerns that request for technical advice may slow case closings, there is a hesitancy by examiners to request formal technical advice. The Peer Review Study revealed that in 8 percent of the CEP cases reviewed was technical advice requested.

It is proposed that technical advice be provided in CEP examinations as follows:

- Expand the services of Counsel in the National Office to provide legal assistance, both written and oral, to Examination personnel on complex tax issues;

- Accelerate the issuance of technical advice by requiring a response within 120 days of receipt;

- The District Counsel attorney designated for the CEP examination should assist in the development and monitoring of the technical advice request as it proceeds through the process;

- The National Office attorney assigned to resolve the technical advice request should be encouraged to communicate extensively with the examiner, including permission to make an on-site visit; and

- While technical advice request is in process, start the Appeals process on other issues.

Better access to technical assistance will improve the quality of examinations, reduce utilization of resources on issues without merit and greatly improve taxpayer cooperation and relations.

ESTABLISHMENT OF GOALS, MEASURES AND TARGET IMPROVEMENT FACTORS

Examination currently monitors the CEP program via AIMS Tables 10, 15, 36, 37, and 39. Measurement parameters include - dollars per return, time per return, dollars per hour, no change rates, and direct exam staff years applied to the CEP program for Revenue Agent, International Agent, Computer Audit Specialist, and Engineer positions. In addition, an automated data base is currently being tested (in Houston) to capture all data from CEP quarterly reports.

Appeals maintains a system to follow the disposition of all work units with disputed amounts of $1 million or more. For those work units $1 million to less than $10 million, the top five issues greater than $100,000 are traced. For work units of $10 million or more, the top 10 issues greater than $100,000 are traced. Counsel recently established a large case program on a less formal basis than Appeals. Their program includes all CEP cases, any case with International or ISP issues, and any cases with proposed deficiencies greater than $1 million.

The overall quality of the CEP would be enhanced through the development of standard measures and goals for Examination, International, Appeals and Counsel. In addition, quality in the CEP program will be improved by creating a customer service environment, focus should be on external customers, including CEP taxpayers and their professional representative organizations (ie., AICPA and ABA).

A Customer Satisfaction Index should be established consisting of a compilation of CEP customer feedback and their perceptions of CEP product/service quality. This index will be used to establish baseline measures, desired performance standards, and identify areas in need of improvement.

Baseline measurement concepts will be utilized to capture current system quality performance in the CEP program. Baselines will be used as an assessment of program status via a combination of customer satisfaction input and internal control measurements. The baseline measures will tie to the Corporate and Functional Critical Success Factors. Suggested areas for baseline measures are:

- Examination CEP Yield Analysis, net operating loss offsets - carrybacks and carryforwards, median range determinations, etc.;
- Appeals sustention rates tracked by uniform monitoring system to Exam's CEP program;
- Litigation of CEP cases by Chief Counsel;
- Industry/Issue Specialization Program key quality indicators; and
- Currency in the CEP program for Examination, Appeals and Counsel.

It is proposed that baseline measures for the CEP program be established on a 10 year trend analysis basis due to the economic patterns of various industries.

The overall objective of the CEP Program would be to assess the major CEP initiatives of:

- Increased revenue to the U.S. Treasury;
- Improved sustention rates; and
- Reduced lapse time.

Presently the quality review of CEP cases is the responsibility of the case managers. This system does not provide trends or indications of non-compliance with auditing standards at the regional or national levels.

It is proposed that a quality assurance system for CEP be established with the following components:

- CEP Quality Peer Review.
- CEP Oversite Committee.

In addition, it is recommended that the Service study the use of outside professional organizations to conduct quality review studies.

CEP Quality Peer Review is currently being tested. This concept is modeled after the AICPA Peer Review System and involves the on-site review of a random sample of recently closed CEP cases. It is recommended that the CEP Quality Peer Review be considered for implementation on a permanent basis. Seven regional on-site review teams, made up of a CEP Branch Chief, domestic Case Managers, and Specialist Managers (International, CAS, and Engineering), have been assigned the review of selected cases in each region (49 nationally). The CEP Quality Peer Review will assess the following key quality indicators in CEP:

- Quality of Examinations;
- Effectiveness of Case Management; and
- Use of Specialists.

The results from Peer Review will be entered into a national data base with dissemination to the CEP Oversite Committee. The Oversite Committee will be composed of seven CEP Branch Chiefs, an Appeals representative, and a Chief Counsel representative. The duties of the CEP Oversite Committee will encompass:

- Managing the CEP Peer Review System;
- Establishing case evaluation procedures;
- Conducting on-site review team training;
- Controlling the national data base from CEP Peer Review;
- Identifying national trends in CEP;
- Identifying systemic problems in CEP; and
- Bringing significant areas of concern to Director, Office of CEP.

IMPROVEMENT TO SUSTENTION RATES AND LAPSE TIME

EXAM SETTLEMENT AUTHORITY

There are no formal provisions giving Examination case managers settlement authority. However, the Peer Review Study found that in 71% of the cases, Appeals Settlement affected the current cycle. The CEP Team followed the Appeals settlement in 69% of the cases and they partially followed the settlement in 31% of the cases.

It is recommended that Examination be given settlement authority over recurring or rollover issues, where the settlement by Appeals is based on the merits of the issues. Providing settlement authority to case managers will result in the earlier resolution of issues and cases. An on-line review of the Examination settlement(s) will be made by the case manager's branch chief to ensure that settlements are proper.

IMPROVE INFORMATION SHARING BETWEEN EXAMINATION, COUNSEL AND APPEALS

Once a case is closed, generally, Examination has little contact with Appeals. Examination personnel traditionally have access to Appeals only through the Revenue Agent Report and comments they make to taxpayers' protests. Taxpayers, on the other hand, have much more direct access to Appeals to make additional arguments, submit additional documents, provide expert reports, etc.

It is recommended that a meeting be held with Appeals, Counsel, and Examination personnel, prior to the initial Appeals conference with the taxpayer. This pre-conference meeting will provide a forum for:

- Discussing issues;
- Discussing the protest;
- Anticipating problems;
- Discussing concerns;
- Discussing issue strengths and weaknesses;

- Understanding respective functional positions; and

- Designating particular issues, including ISP, which will provide for continuing dialogue with Appeals prior to settlement by concession or substantial compromise.

Appeals will have continuing discussions with Examination when new arguments or developments arise on issues in Appeals cases. A post-closing conference with Appeals, Counsel and Examination will be held after the completion of Appeals activity. At the post-closing conference, Appeals will discuss the resolution of the unagreed issues. The forum would provide Examination with information for auditing subsequent cycles.

COST ANALYSIS & TARGETED IMPROVEMENTS

The additional costs to implement the above proposals for Examination are approximately $4.6 million. This includes 48 additional positions in the National and Regional offices. Additional costs have not been attributed to increased Industry/Issue specialists and District ISP coordinators since their time will offset staff time currently being applied in CEP.

Office space, computers, telephone, travel and moving expenses are detailed below.

	Present Staff	Proposed Staff	Difference	Proposed Budget
National Subtotal	16	36	20	$1,191,315.00
Support Costs (N.O.)				$285,337.80
N.O. Total				$1,476,652.80
Regional Office Subtotal		28	28	$1,656,809.00
Support Costs (R.O.)				$181,231.40
R.O. Total				$1,838,040.40
Travel				$600,000.00
Moving Expenses $45,000 ea.				$685,000.00
TOTAL WITH RELOCATION				$4,599,693.20

TARGETED IMPROVEMENTS

For FY 1991, the proposals delegating settlement authority to case managers, strengthening specialization programs, improving the use of outside experts, increasing legal and technical assistance to examination personnel and strengthening management controls and accountability will accelerate collection of revenue by $550,000,000. Methodology for tracking the collection of revenue is outlined in the FY 1991 compliance management initiatives.

Specific goals for FY 1992 and beyond are target improvements to yield, timeliness, sustention rates, taxpayer cooperation and other critical success factors. These will be developed with input from IRS and outside customers. During FY 1991, baselines will be established for measuring and assessing quality, efficiency and timeliness.

PRESENT AND PROPOSED ORGANIZATION STRUCTURE

Attachments I - Present National Office Organizational structure for CEP.

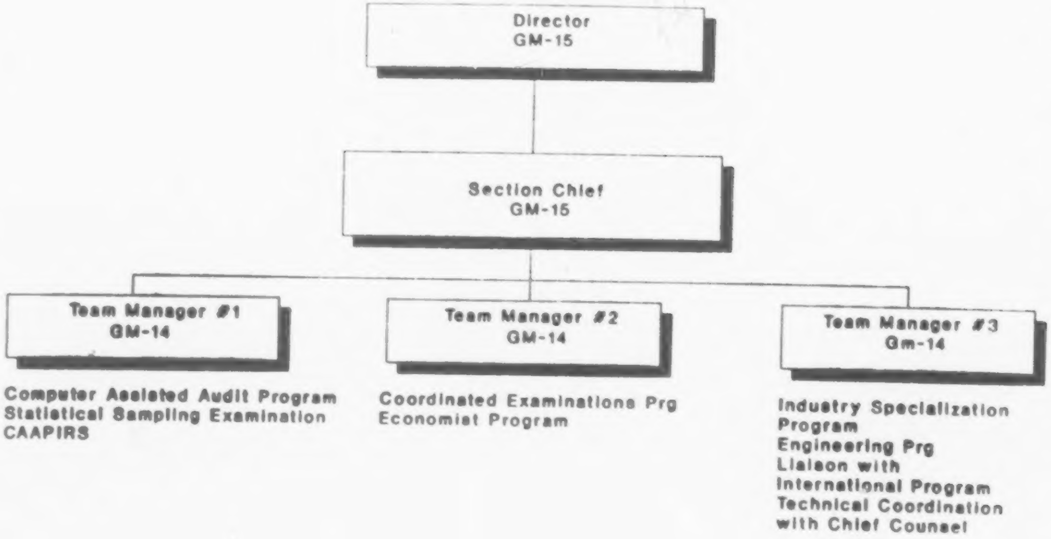
Attachment IIA-IIC - Proposed National Office Organizational structure for CEP.

Attachment III - Present Regional Office structure for CEP.

Attachment IV - Proposed Regional Office structure for CEP.

NATIONAL PROGRAMS SECTION
SECTION CHIEF

(Present)



Director
GM-15

Section Chief
GM-15

Team Manager #1
GM-14

Computer Assisted Audit Program
Statistical Sampling Examination
CAAPIRS

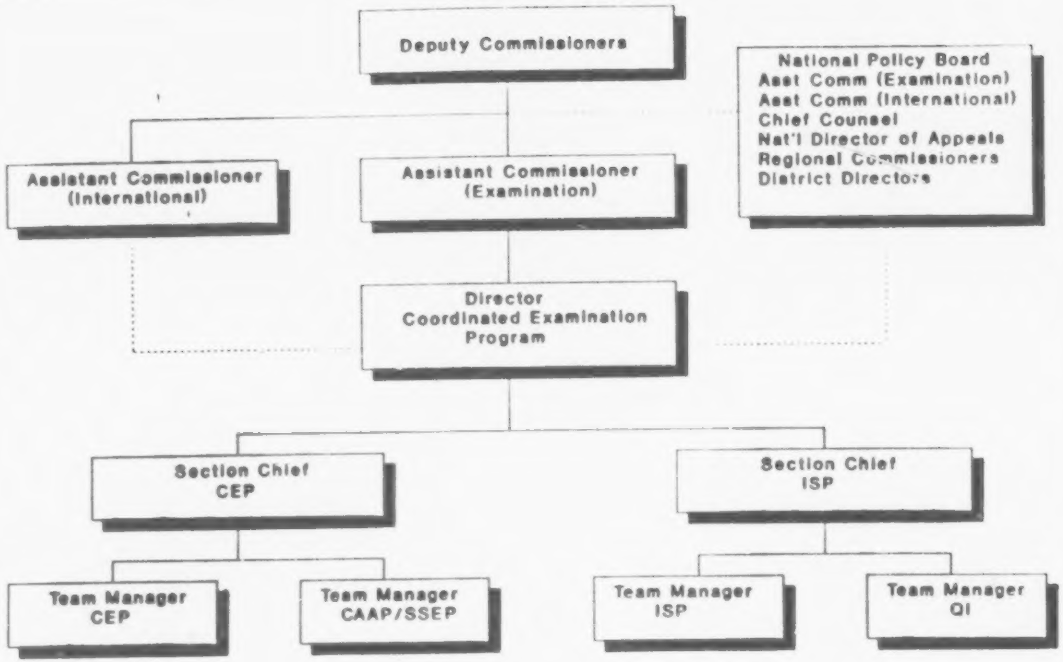
Team Manager #2
GM-14

Coordinated Examinations Prg
Economist Program

Team Manager #3
Gm-14

Industry Specialization Program
Engineering Prg
Liaison with International Program
Technical Coordination with Chief Counsel

Attachment I

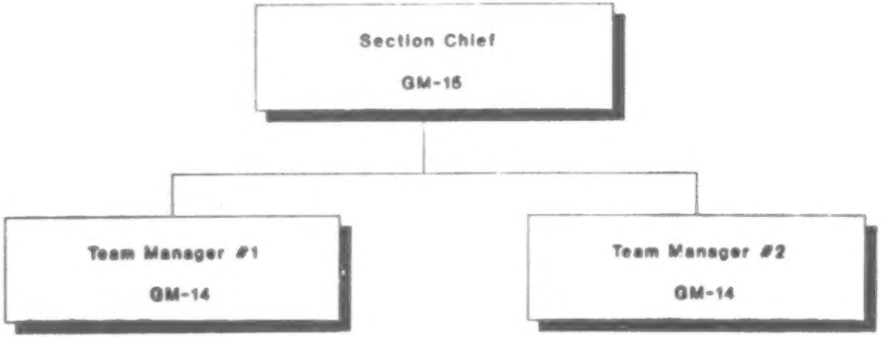

Deputy Commissioners
National Policy Board
Asst Comm (Examination)
Asst Comm (International)
Chief Counsel
Nat'l Director of Appeals
Regional Commissioners
District Directors
Assistant Commissioner (International)
Assistant Commissioner (Examination)
Director Coordinated Examination Program
Section Chief CEP
Section Chief ISP
Team Manager CEP
Team Manager CAAP/SSEP
Team Manager ISP
Team Manager QI

(Proposed)
Director, Coordinated Examination Program

Attachment II-A

Coordinated Examinations
ISP Section Chief

(Proposed)



Section Chief

GM-15

Team Manager #1

GM-14

Team Manager #2

GM-14

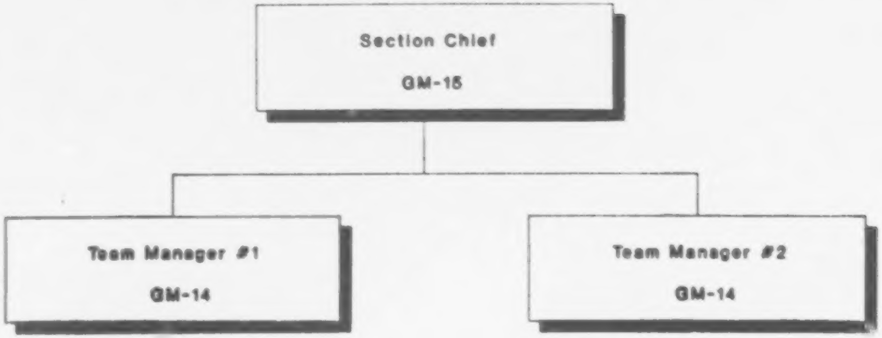
Industry Specialization Program
-Technical Specialization
--Industry
--Issue
-Audit Technique Handbook
-Outside Expert Program

Quality Improvement Program
-Advanced Training
--CEP and Specialists
--(Except CAS)
-Quality Improvement Initiatives
-Annual Business Plan
--Baselines and Target
--Improvement Factors
-Quality Assurance and
--Measurement (Peer Review)
-Engineers
-Economists

Attachment II-9

Coordinated Examinations
CEP Section Chief

(Proposed)



Section Chief

GM-15

Team Manager #1

GM-14

Team Manager #2

GM-14

Coordinated Examination Programs
-Development/Oversight
-Functional Reviews
--Examination Case Planning
--Support Audits
--Taxpayer Cooperation
--CEP IRM/Handbook
-Advanced Pricing Determination

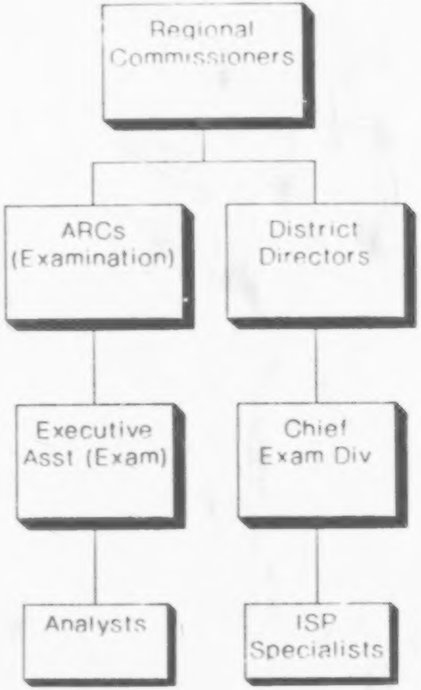
Computer Assisted Audit Program
-Statistical Sampling Examination Pr
-CAS Training
-Electronic Bulletin Board
-Expert System Development
-Issue Tracking

Attachment II-C

Regional Commissioners

Coordinated Examination

(Present)



Regional Commissioners

ARCs (Examination)

District Directors

Executive Asst (Exam)

Chief Exam Div

Analysts

ISP Specialists

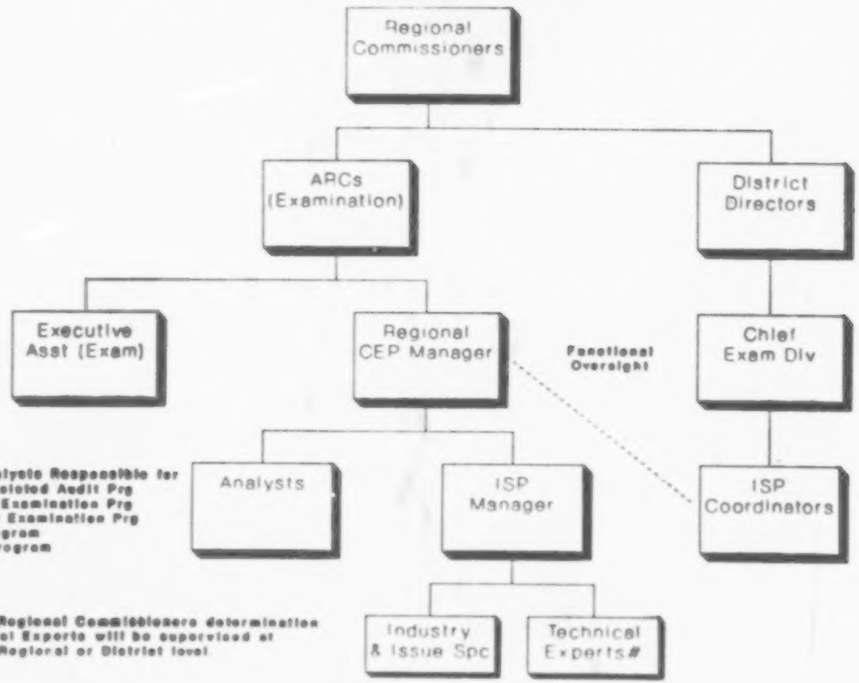
Regional Analysts Responsible for
Computer Assisted Audit Prg
Coordinated Examinations Prg
International Examination Prg
Engineer Program

Attachment III

Regional Commissioners

Coordinated Examination

(Proposed)


Regional Commissioners
ARCs (Examination)
District Directors
Executive Asst (Exam)
Regional CEP Manager
Functional Oversight
Chief Exam Div
Analysts
ISP Manager
ISP Coordinators
Industry & Issue Spc
Technical Experts#

Regional Analysts Responsible for
Computer Assisted Audit Prg
Coordinated Examination Prg
International Examination Prg
Engineer Program
Economist Program

# Based on Regional Commissioners determination
Technical Experts will be supervised at
Regional or District level

Attachment IV

Located in District Offices

COUNSEL LARGE CASE PROGRAM PROPOSAL

Counsel concurs with most of the Examination CEP Task Force Report (dated April 4, 1990) recommendations with respect to proposed changes and improvements to the Coordinated Examination Program. At the outset, it should be emphasized that perhaps the single most important change to the large case environment has already taken place; in response to the Phillips CEP QIP report, national, regional and local management officials in Examination, Appeals and Counsel have already begun to analyze and deal with many of the problems and inadequacies that hinder optimum functioning of the Large Case Program. The proposals set forth herein and in the Examination CEP Task Force Report should facilitate demonstrable quality improvements to CEP.

Counsel has already made and is proposing additional organizational and systemic changes combined with various initiatives that are designed to improve our service to the Large Case Program.

First, Counsel has established the Large Case Program Manager function in the national office to serve as the focal point for our program support.

Second, there will be established in each region a Regional Large Case Coordinator position designed to facilitate communications between field attorneys, the regions, and the national office.

Third, Counsel is committed both to providing local attorney support for every Large Case and to making national office attorney resources available to the field as appropriate.

Fourth, Counsel has begun and will continue a nationally coordinated effort to develop comprehensive litigation and compliance strategies for significant Large Case issues.

Fifth, Counsel will work with Examination and Appeals to review and analyze the Industry Specialization Program in an effort to improve critical issue coverage, develop additional industry categories, combine and refine existing industry categories (as appropriate), and explore expanded issue specialization.

Herein follows a discussion of these organizational and systemic changes as well as some of the initiatives Counsel will be pursuing. As indicated above, while Counsel endorses most of the Examination CEP Task Force's recommendations, nonetheless we disagree with the proposal to establish a National Policy Board (our concerns are set forth below).

ORGANIZATIONAL RECOMMENDATIONS

With respect to the Task Force's proposed Examination function organizational proposals, we believe that the establishing of a National Office Director (Office of CEP), Regional CEP Managers (and support staff), and District CEP Managers/ISP Coordinators will address the problem of lack of accountability for CEP that currently exists. Examination's proposal will put in place a management structure/system that is designed to improve communications between program and case managers as well as to elevate critical policy issues/concerns to the regions and national office for resolution.

Counsel believes that a radical, centralized restructuring of its own organization (as proposed in the Phillips report) is ill-conceived. But we recognize that increased Large Case Program emphasis is necessary if we are to provide quality service to our client. To that end, Counsel has recently established the Large Case Program Manager (and staff) function. Moreover, we believe that the addition of Large Case coordinators at the Regional Counsel level will improve field management and oversight of the Large Case Program. We believe that key program objectives and goals should immediately be integrated into management officials' goals and critical elements so as to ensure accountability.

Large Case Program Manager. Counsel recently has recognized the need for a more focused, nationally coordinated program than has heretofore existed. To that end, in January, 1990, Counsel established the Large Case Program Manager and support staff within the Office of Associate Chief Counsel (Litigation). This new function will assume an active and direct role in coordinating, facilitating, and monitoring Counsel's activities in the Large Case Program.

Key areas of involvement for the Large Case Program Manager and staff (presently two attorney positions) will be to assist in focusing resources on critical issues and to oversee the development of specific, comprehensive litigation strategies and compliance objectives. The Large Case Program Manager function would also work directly with the proposed new Examination CEP structure (Director, Office of CEP) and the Office of Large Case, Appeals. The new function will generally coordinate and oversee the development of training objectives and programs. An organizational chart is attached as Attachment A.

Regional Large Case Coordinators. Each Regional Counsel will establish a Regional Large Case Coordinator attorney position (GM-15). The Regional Large Case Coordinator will be responsible for building a communication network with both field attorneys and the national office, monitoring the field's involvement in large cases, and facilitating the Counsel objective of providing the best possible assistance and resources to Examination and Appeals. In addition, the Regional Counsels will exercise direct line and program authority over all Industry Counsels in the field.

National Policy Board. Counsel does not concur with the proposal to establish a National Policy Board. The stated purpose of the proposed board is to serve to focus high level executive attention on CEP from a multi-functional perspective by addressing policy issues, performance goals, coordination problems, issue identification, litigation strategies, etc.

We question the need for such a board for several reasons. First, the proposed restructuring of Examination, Appeals, and Counsel will greatly enhance local, regional, and national office management's ability to identify and resolve problems. Secondly, within the past months, national office and regional management policy officials have already demonstrated an increased commitment to and responsibility for the operation and oversight of the Large Case Program -- and that commitment will continue. Thirdly, there is a strong probability that the proposed National Policy Board would inhibit the expeditious resolution of problems because of time delays necessary to convene the board and the necessity for each board member to be fully briefed prior to each board meeting. We believe that the present Regional-National Office management structure will more expeditiously resolve critical policy issues. Many of the activities envisioned by the Examination Task Force for the Policy Board are more appropriately resolved at lower management levels or without multifunctional involvement.

SYSTEMIC RECOMMENDATIONS & LARGE CASE INITIATIVES

Counsel endorses the Examination Task Force recommendations designed to improve program communication, expand and better our training, improve our utilization of outside experts, improve recovery rates and reduce the time that it takes to resolve large cases. Many of the proposals will require further study, and Counsel anticipates being actively involved in the process.

Counsel Assistance to Examination. Already Counsel has, when requested by Examination, assigned experienced attorneys to large cases, and we will continue to do so. The assigning of attorneys to large cases will facilitate information gathering, the providing of technical advice, and the formulation of comprehensive litigation strategies. In addition, National Office Technical, International, and Litigation attorneys will be made available to assist field counsel, Revenue Agents, and Appeals Officers on key large case issues.

We intend to have National Office attorneys play a direct role in providing prompt technical assistance (both formal and informal), audit planning assistance, and training to all field functions for critical large case issues.

Counsel will be taking steps to improve issue identification and case planning at the Examination level. This process will involve not only field personnel, but also Technical, International, and Litigation national office attorneys with specific expertise. For example, we have established a Leveraged Buyout Debt-Equity Working Group that will be identifying and analyzing potential debt-equity issues, generating position papers, and finally, working with Examination to develop an overall compliance plan. A description of the LBO Debt-Equity Initiative is attached as Attachment B. Additional initiatives will be developed in an effort to improve the issue identification and Examination planning process.

Strengthening ISP. The Examination CEP Task Force has proposed improving the Industry Specialization Program by considering expansion of industry categories, addition of so-called issue specialists, and consideration of the "controlled issue" system utilized by the Petroleum ISP. We will be proposing to Examination that a task force be convened to study the current ISP structure and make recommendations as to specific changes.

We find that many issues are not industry-specific; rather, the issues cross industry boundaries, thereby making the coordination process more difficult. Counsel and Examination have already responded to the cross-industry issue phenomenon, issuing so-called "generic" coordinated issue papers which apply to any ISP industry where the issue is present. For example, coordinated issue papers have been issued for workforce intangibles, market based intangibles, and customer based intangibles.

We are increasingly focusing on the concept of issue and transactional specialization for complex issues that arise in multiple industries. For example, Leverage Buyouts and Financial Products are ISP categories that focus on issues and transactions. The proposed task force would explore the need for additional issue specialization. In addition, we will continue to explore so-called transactional audits.

Development of Litigation Strategies. The Phillips Report criticized the lack of overall litigation strategies. The present system whereby individual cases with key issues are "designated" for litigation does not specifically contemplate comprehensive strategies. For example, an Industry Team may identify one test case for litigation, ignoring the need for multiple circuit court coverage. In other instances, one Industry Team may be developing a possible test case for litigation without the knowledge that a better test case exists in a different industry.

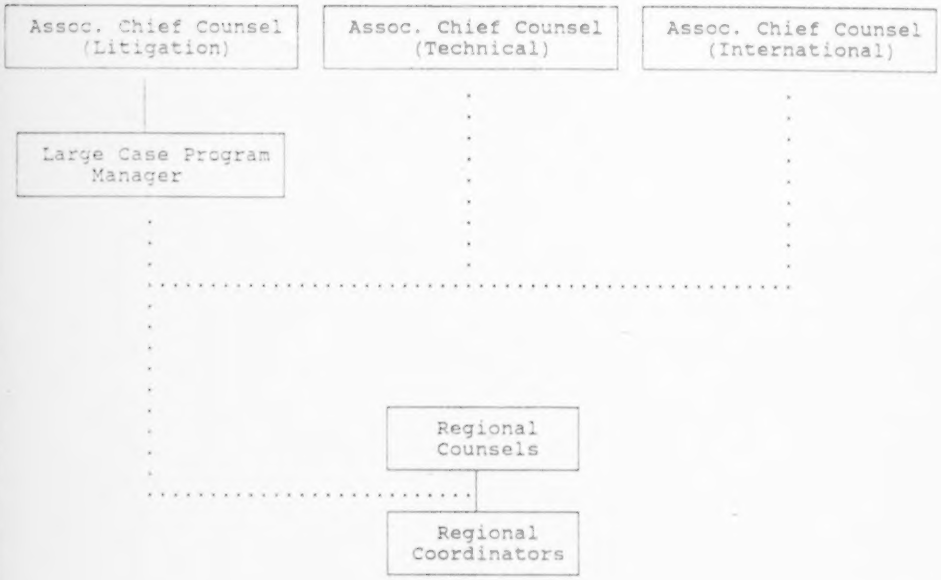
Counsel recognizes the need to develop comprehensive, industry-wide litigation objectives. We have already set into motion various initiatives designed to develop litigation objectives and serve as models for future development of litigation strategies. For example, a description of the Intangible Asset Initiative is attached as Attachment C. We will be exploring additional litigation initiatives, including the establishing of comprehensive litigation projects designed to more efficiently deal with large cases involving the same or similar issues.

Training. In response to the obvious need for specialized training, Counsel has already begun an in-house large case training program. To date, two five-day Large Case Schools have been held. In May, Counsel will hold its first Large Case Workshop which is designed not only as a training seminar, but also as an CEP/ISP coordination/communication meeting for our front-line large case program attorneys (STAs, ISTAs, ISPs, and other senior attorneys actively involved in the program).

Counsel has also proposed -- and Examination has agreed to consider -- a national cross-functional (Examination, Appeals and Counsel) Large Case/ISP/CEP conference later this year to serve as a communication forum and training session.

Counsel will continue out-service training for attorneys -- including our well-received Federal Bar Association "Meeting of the Minds" seminars which bring together government and private sector attorneys on topics of current interest. (Contemporaneous with the FBA seminars, in house ISP working sessions were held.) We are also exploring the concept of specialized training for our attorneys by members of the private bar and universities. (For example, the accounting firm Ernst & Young provided speakers and materials for our two Large Case Schools.)

Communication/Coordination/Training. Counsel has in place a basic case and ISP issue tracking system (CATS) for docketed large cases. In addition, Counsel currently maintains a CEP data base system that tracks some large case issues. We will be working with Examination and Appeals to improve and expand our issue/case tracking capabilities for nondocketed cases.


Assoc. Chief Counsel (Litigation)
Assoc. Chief Counsel (Technical)
Assoc. Chief Counsel (International)
Large Case Program Manager
Regional Counsels
Regional Coordinators

ATTACHMENT A

DEBT-EQUITY WORKING GROUP & INITIATIVE

The Service has to date not focused on debt-equity issues. Many within the Service suspect -- but do not know with certainty -- that there are debt-equity compliance issues which should be addressed. The Service should be doing a better, more efficient job of identifying, analyzing, and, as appropriate, developing potential debt-equity issues in LBO cases. Absent a concentrated investigation and evaluation process, it could well take years for the Service to identify viable (if there are any) debt-equity issues and develop positions with respect thereto. In order to more effectively utilize our limited resources, a Debt-Equity Working Group was established to formulate and implement an initiative designed to expeditiously conduct "R&D" so as to identify potential issues, to analyze those issues, to develop positions, and to a develop comprehensive compliance/litigation strategy, as appropriate.

PHASE ONE. The Large Case Program Manager proposed and established the debt-equity working group comprised of the LBO Industry Specialist and attorneys from Technical, Litigation, and International. The group will first meet in late March, 1990, and will develop a workplan to enable the team to (1) identify and analyze potential debt-equity issues; (2) to determine the need for coordination of those issues and to develop technical positions (in conjunction with other national office attorneys/functions); and (3) to develop and implement a comprehensive compliance/litigation strategy.

PHASE TWO. The working group will identify cases, analyze case information, SEC filings, and other information pertaining to possible debt-equity issues. As potential compliance issues are identified, the team will evaluate those issues and, if they are viable, develop proposed position papers which will then be coordinated with the appropriate national office functions.

PHASE THREE. The final stage of the initiative will involve the development and implementation of a comprehensive compliance/litigation strategy for key debt-equity issues. Test case selection criteria will be developed. Working with ISP/CEP field personnel, the group will then attempt to target and litigate test cases as expeditiously as possible. Settlement guidance will also be developed.

ATTACHMENT B

INTANGIBLE ASSET WORKING GROUP & INITIATIVE

In early 1989, the Service began to intensively focus on LBO/M&A compliance issues. Intangible asset amortization issues were identified as involving significant compliance concerns as well as substantial lost tax revenues. Because intangible issues were (with very few exceptions) not being coordinated within CEP/ISP, Counsel designed an initiative to identify intangible asset amortization issues, analyze and categorize those issues, determine positions, and designate test cases for expeditious litigation pursuant to a comprehensive litigation strategy. An Intangible Asset Working Group was established to spearhead the initiative, under the direction of the Large Case Program Manager. A brief description of each phase of the project follows.

PHASE ONE. Counsel initiated a manual survey of all nondocketed and docketed cases to identify intangible issues and measure the tax revenue implications. That survey revealed a total of 2,278 intangible asset amortization issues involving over $8.5 billion in proposed adjustments.

PHASE TWO. The working group analyzed the survey data and held discussions with field personnel working on intangible issues in an effort to group the numerous intangibles into categories based on similarities/common elements. The various intangibles have been grouped into : Customer Based Intangibles (e.g., customer lists, core deposits), Market Based Intangibles (e.g., underdeveloped markets, premium population growth), Favorable Contract Intangibles (e.g., favorable financing, favorable supply contracts), Work Force Intangibles (e.g., assembled work force, agency structure), Section 1253(franchise) Intangibles (e.g., network affiliation agreements, FCC licenses), Informational Intangibles (e.g., policies manuals, training programs) and Other Intangibles (e.g., software, covenants-not-to compete). Positions for each of the intangible groups have been developed and Coordinated Issue Papers have been issued to the field.

PHASE THREE. The final -- and most complex -- stage of the initiative involves the development and implementation of a comprehensive compliance/litigation strategy for key intangible issues. Test case selection criteria will be developed that will serve as the basis for the identification of test cases for each intangible area. Working with ISP/CEP field personnel, we will then attempt to target and litigate test cases (with multiple circuit court coverage) as expeditiously as possible. Also, we are exploring mechanisms for providing settlement guidance to Appeals and Counsel -- based on the assumption that the majority of cases will be settled.

ATTACHMENT C

APPEALS LARGE CASE PROGRAM PROPOSAL

Overview

There are five major areas affecting Appeals in which proposals are being made as a result of the Quality Improvement Team Report on the Coordinated Examination Program. These areas are:

I. Organizational Structure (including Policy Board)

II. Delegation of Settlement Authority

III. Industry Specialization Program (ISP)

IV. Relationships Between Examination and Appeals

V. Skills/Specialization of IRS Personnel

The sources of the various proposals include: a) the Quality Improvement Team report, b) the Examination CEP Task Force Report, c) top Counsel management, and d) the Deputy Associate Chief Counsel (Litigation). The Regional Directors of Appeals met in Washington, D.C., on February 27 and 28, 1990, to formulate the Appeals' position in the light of all these proposals; that position was subsequently refined after discussions between the National Director of Appeals and top Counsel management.

Summary of Appeals' Position

Appeals agrees with the Counsel Large Case Program Proposal **except** in one area:

> Appeals believes the pre-conference meeting with Examination is the place to explore all issues and opposes the idea of designating issues that would **require** meeting during the settlement process to discuss the potential Appeals settlement proposal. Appeals is agreeable, however, to a continuing dialogue with Examination as appropriate in a particular case. (Discussed in Relationships Between Examination and Appeals, p. 3)

Appeals has reservations about Examination's proposal to expand the controlled issue concept. (Discussed in Delegation of Settlement Authority, p. 2)

Specific Appeals' Positions

I. Organizational Structure (including Policy Board)

Appeals does not endorse the major structural change proposed in the Quality Improvement Team Report.

Appeals believes that the focus of management control in Appeals for large case matters should be elevated and centralized to the **regional level**. Where workload and span of control are appropriate, an Assistant Regional Director of Appeals may be established in each region with overall responsibility for CEP matters and line authority for the Appeals team chiefs and industry specialization coordinators. This view is consistent with the Regional Counsel position.

At the **national level**, Appeals believes the current Office of Large Case Programs headed by a GM-15 Office Director who reports to the Deputy National Director of Appeals ably fulfills the role intended for the Assistant National Director of Appeals proposed by Regional Counsel. Since being established in late 1988, the Office of Large Case Programs has been the national focal point in Appeals for large case matters.

Appeals initially supported a high-level national policy board and regional boards to provide clear **policy guidance and coordination** across the functions. However, Appeals recognizes that the strategic business planning process undertaken by both the Chief Counsel and Commissioner encourages cross-functional approaches to programs. This strategic planning framework is relatively recent and may well provide the necessary impetus to coordinated program planning that was previously lacking and was sought for in the policy board suggestion. Thus, the recommendation, in lieu of formal policy boards, is that the officials with responsibility for large cases meet, confer, and plan the Service's large case program on a regular basis.

II. Delegation of Settlement Authority

Appeals agrees with the concept of delegating settlement authority to Examination on **roll-over, recurring issues** that were subject to merit settlements in Appeals. This position is consistent with the proposals in the Quality Improvement Team Report, the Examination CEP Task Force report, and Regional Counsel views. However, Appeals believes it should retain **post review authority** over the Examination settlements.

Appeals has reservations about Examination's proposal to expand the controlled issue concept. There is little detail in Examination's CEP Task Force Report, but conversations with Examination personnel reveal some intention to make blanket authorizations that would include all industry issues. Appeals does not have jurisdiction on controlled issues. If this proposal covers all industry issues, it would be a radical departure from current procedures and would have the effect of forcing taxpayers to litigate, rather than appeal administratively, any disagreements with Examination.

III. Industry Specialization Program (ISP)

As discussed under "Organizational Structure" above, Appeals believes the Appeals Industry Specialization Coordinators should **report to the region**. **Other assignments** need to be **limited** to enable them to spend sufficient time on industry coordination.

An Appeals **task force** has developed recommendations for **strengthening the Industry Specialization Program in Appeals**. These recommendations will be presented to the Regional Directors of Appeals at their April meeting.

Appeals endorses the idea of issuing **written guidelines** covering factors Appeals officers should consider in developing settlement positions on industry issues. However, more details are needed as to who would have input and approval of the guidelines and their effect; Appeals is opposed to guidelines that would have the effect of stopping appropriate settlements.

The Appeals' views and the task force activity are consistent with the positions of Examination and Counsel.

IV. Relationships between Examination and Appeals

Appeals supports the idea of **meeting with Examination before holding an Appeals conference** with the taxpayer. This view is consistent with Regional Counsel and Examination.

Regional Counsel previously proposed that Examination and Counsel be able to **designate issues on which Appeals must meet** with them before conceding or substantially compromising; Appeals would, however, retain settlement authority. Appeals believes that the pre-conference meeting is the place to explore these issues in full and does not support the idea of **requiring** an additional meeting during the settlement process.

Appeals agrees with Examination's and Regional Counsel's views that a **post-closing conference** should be held to discuss the basis for settlement, issue and case development concerns for the future, and any other pertinent matters.

V. Skills/Specialization of IRS Personnel

Concerning the concept of **issue specialists**, Appeals believes that there are already many issue specialists in the National Office. The Service should make better use of their expertise, rather than launch an ambitious program of developing issue specialists in the field. This view is consistent with Regional Counsel.

Appeals agrees with Regional Counsel about the need for **Appeals International Specialists**.

Appeals supports the various proposals for **cross-functional training** and already has an active program of international seminars that include Appeals, Counsel, and Examination personnel. Appeals would expect to be part of the group that will design the new training.

Chairman PICKLE. Well, we thank you, Mr. Goldberg. You have given us a very good statement. I think you made an honest appraisal of our overall problem. I like your attitude and your general approach and suggestions. I think that you individually want to make some progress in this area.

Now, we want to ask you some questions about your statement. I am going to ask that before we start asking the questions, I want to ask the representatives from the General Accounting Office all to come up to the witness table. You don't have to move because we got two seats here.

We have Messrs. Paul Posner, Tom Short, and Mark Gillen here with us. I understand that the GAO has a short statement that they would like to make. I think it would be useful to have both the GAO and the IRS respond to the members' questions at the same time. I understand your GAO statement is short. Do you have enough chairs? Well, if another individual needs to be there, he can step up to the microphone. Is that agreeable?

Mr. POSNER. That is fine.

Chairman PICKLE. All right. Who will make the primary statement?

Mr. POSNER. I will, Mr. Chairman.

Chairman PICKLE. You will make it, Mr. Posner?

Mr. POSNER. Yes.

Chairman PICKLE. If you will do that, I think after you make your statement, then the members' questions will be asked of either one or both of you, and we will just do it together. Proceed, Mr. Posner.

STATEMENT OF PAUL L. POSNER, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY TOM SHORT, ASSIGNMENT MANAGER; AND MARK GILLEN, ASSISTANT DIRECTOR

Mr. POSNER. Thank you, Mr. Chairman, and members of the subcommittee. Let me introduce Mark Gillen, who is our Assistant Director, on my left, and Tom Short, who is sitting behind him and is largely responsible for this report that you released on the profiles of the tax gap.

As you know, Mr. Chairman, IRS defines the gross tax gap as the difference between the amount of income tax that taxpayers owe and the amount they voluntarily pay for a calendar year. In this testimony, I will discuss more specifically the size of the tax gap, our analysis of the IRS' data on the tax gap, their programs for reducing it, along with ideas for improving the programs. Now, reducing the tax gap is an important challenge given its potential negative effects on public confidence in the voluntary tax system and on the budget deficit. Clearly, more could be done to reduce it, but the real questions are how and with what resources.

Knowing the specific nature and causes of noncompliance we feel could help IRS better target its enforcement resources to reduce the gap. However, the tax gap estimate is currently aggregated by broad categories of taxpayers and doesn't provide sufficiently detailed information on who or what causes the noncompliance. As a result, IRS can't evaluate how well its enforcement programs are reducing specific parts of the tax gap. So, to gain insight into the nature and causes, you asked us to analyze the major components of the IRS gross tax gap estimate for 1987.

Our work illustrates, we feel, that IRS could further analyze the tax gap data to gain valuable insights on the nature of noncompliance and the issues, as well as help evaluate its ability to further reduce the pockets of the tax gap.

Now, let me briefly discuss the four components that we analyzed at your request: the sole proprietors or self-employed workers who file schedule C's on their tax return; informal suppliers or self-employed workers, such as street vendors who operate on a cash basis; small corporations, or those with less than $10 million in assets; and large corporations, those with over $10 million. These four components accounted for over half of the $84.9 billion tax gap in 1987.

Sole proprietors accounted for $16.6 billion, or about 20 percent of the 1987 gross tax gap based on IRS figures. IRS' examinations showed that this group underpaid about 23 percent of their tax liabilities, reflecting both unreported income as well as overstated deductions. Of the eight types of sole proprietors, those who underpaid the most were service providers, producers of goods, and sellers of goods at fixed locations.

Informal suppliers accounted for about $7.7 billion, or 9 percent of the tax gap. Because they operate in cash, their income is often neither documented nor subject to third-party controls. Of the 16 types of informal suppliers, those accounting for the most noncompliance were those making home repairs, providing child care, or selling food at roadside stands.

Small corporations accounted for another $5.2 billion, or 6 percent of the tax gap. Their noncompliance was about equally divided between unreported income and overstated deductions.

Large corporations accounted for $15.8 billion, or about 19 percent of the gap. IRS largely attributed their noncompliance to improper accounting for reported income and deductions. For example, they misallocated income among foreign and domestic subsidiaries and misstated periods for depreciating or expensing assets. Of the 27 types of industries, those with the most noncompliance were concentrated in petroleum and banking.

Now, research by IRS and others offers some insight into the reasons for noncompliance in a broad sense. First, it generally occurs due to uncertainty about tax laws or a desire to increase profits to survive competition. For example, noncompliance by sole proprietors and small corporations often resulted from confusion over their tax liabilities, or, alternatively, from efforts to increase their profits by reducing their tax liabilities. For large corporations, complex vague tax laws contributed to the noncompliance; for example, determining what expenses can be deducted under the research credit and can be counted towards the research credit.

Second, studies show that noncompliance is more prevalent and difficult to pursue when taxes are not withheld and information returns are not submitted. IRS studies show that taxpayers report almost all wages and salaries, which are withheld, and interest and dividends, which are subject to information reporting. But they only report 13 percent of informal supplier income, which is generally off the books, so to speak.

IRS generally doesn't design its major enforcement programs to pursue the components of the tax gap. With some limited exceptions, these programs address noncompliance in a general way by focusing on the types of tax returns rather than the type of noncompliance. As a result, it is difficult to align these programs with the tax gap components. Although IRS feels their enforcement programs are effective—and there are strengths, obviously—the programs have some problems, such as those that IRS itself pointed to in its statement.

For example, as we know, the rate for examining returns has dropped to about 1 percent for individual and under 2 percent for corporations. Somewhat more alarming is that has also dropped for specific components of the tax gap where we have fairly high noncompliance. However, because IRS has focused its examinations on cases with higher potential for revenue yields, the revenue yield has, in fact, increased.

For those returns that are examined, IRS officials have expressed concern about whether examiners can identify all the noncompliance and recommend assessments that can withstand appeals, particularly with regard to unreported income, which makes up so much of the tax gap. In 1989, the research division in IRS estimated that individuals appeal about 63 percent of the amount of recommended assessments while large corporations appeal about 81 percent. It also estimated more alarmingly that IRS loses about 70 percent of the amount of recommended assessments. Further, IRS estimates that income tax examinations only uncover a certain portion of unreported income, as I said earlier.

IRS does have another program which is very effective in disclosing unreported income, the document matching program, and it did generate over $1.8 billion in recommended taxes and penalties. However, IRS doesn't have the resources to investigate all indications of unreported income that emerge from matching; further, they have not expanded the program as of yet to include payments to all types of businesses including corporations.

IRS recognizes these limits and has some initiatives to improve enforcement. For example, IRS has a special examination program it discussed in its statement to probe for unreported income by sole proprietors. It also developed a cross-index file to better enable it to match information returns with tax returns for sole proprietors.

The limitations on IRS' current approach, the size of the tax gap and the continuing persistence of it, have prompted outside observers, as well as IRS officials, to offer ideas for improving enforcement, some of which we have cataloged in the report. It is important to note that we didn't evaluate the ideas except when we ourselves had made recommendations, but, nevertheless, we included them for your examination.

In 1989, for example, we recommended using information returns to more systematically target employers who are misclassifying employees as independent contractors. Misclassification lowers Federal revenues because taxes are not withheld and independent contractors usually are less compliant. We have also recommended that IRS develop a business document-matching program to, among other things, identify corporations not reporting income or filing tax returns. IRS is currently studying the feasibility of both recommendations.

We believe a lot of these ideas warrant consideration and demonstrate the value of looking beyond IRS, as well as within IRS, for both ideas and resources. Given a limited budget, however, IRS needs to decide which ones would most cost effectively reduce the tax gap. We know, for example, from our past work that simply increasing enforcement resources will not lower the gap very quickly. In 1988, we reported that an attempt to hire more examiners didn't produce revenues within the timeframes that Congress envisioned. IRS couldn't quickly hire the allotted number of examiners and then easily train and absorb them to do examinations without lowering the productivity of their other experienced revenue agents who were pulled in off the line to help with training. In essence, our work showed that not only does IRS need better information on resources and examination results, but that increasing IRS resources can't be the sole response to quickly reverse a growing tax gap.

Instead, we believe a multifaceted approach is needed to attack the many dimensions of noncompliance. IRS could build on its partnerships with third parties to enhance its overall enforcement efforts and better stretch its limited resources. Employers can help by withholding income taxes and depositing the taxes in a timely manner. They also can help by properly classifying workers as employees instead of independent contractors. Business and Government entities help by submitting information returns to report payments, which enables IRS to match them with tax returns. Representatives of taxpayers and tax practitioners can help by encouraging and assisting taxpayers to comply.

Even with such help, we agree with IRS that it cannot simply rely on enforcement alone. Taxpayer assistance and education play important roles in encouraging compliance. IRS must continue with the help of third parties to assist taxpayers. IRS has been offering workshops for small businesses and testing innovative ways to help small businesses comply. IRS also must continue to educate taxpayers about their compliance responsibilities and enlist their support in improving compliance.

Now, we recognize that any changes, particularly in enforcement, may generate concerns and may have to ultimately be subject to delicate tradeoff decisions. For example, improved enforcement or innovative enforcement programs may have startup costs that may exceed benefits. New administrative or paperwork burdens might be opposed by some taxpayers. Taxpayers' support may diminish when better enforcement, such as expanded information reporting, increases paperwork burdens along with potentially the costs of doing business. Even so, we believe that the concerns can be addressed to minimize burdens and that a lower tax gap is worth some additional costs and risks.

Now, one final point addresses our belief that IRS can better use its tax gap data to better analyze and evaluate its enforcement programs. Knowing more about noncompliance could allow IRS, we believe, to better target its enforcement resources on the troublesome pockets of the tax gap.

We believe also that such knowledge could provide IRS with a better basis to evaluate the effectiveness of its programs. Although IRS estimates the total revenues produced by its enforcement programs—and IRS has just given you the net tax gap report which does that—it doesn't have sufficient data to track the issues most responsible for the tax gap and, more importantly, to assess whether its programs reduce noncompliance by the components of the tax gap. For example, with the exception of TCMP, IRS does not track the issues of noncompliance raised through its examinations. Without such tracking, it is difficult for them to evaluate whether its examinations successfully deal with the major issues causing the tax gap for such components as large corporations or sole proprietorships. The lack of such an issue-tracking system, from examinations all the way through appeals and ultimately to collection, has complicated IRS' efforts to better understand the problems with its programs or to evaluate solutions.

IRS has recognized that it needs to know more both about noncompliance as well as about its enforcement results. For example, to detect noncompliance early, they now have teams of employees who are reviewing samples of tax returns at all service centers. IRS has also been moving as of late to improve its information about enforcement results. For example, based on a promising 1989 study, IRS is using more recent data and is revising assumptions on how much recommended tax actually gets assessed and collected through the pipeline. The report also outlined future improvements such as compiling actual revenue by type of tax and the year of tax liability, and developing a system to capture the flow of enforcement revenue across the various functions within the agency, including Exam, Collection, and Appeals.

Further, IRS is undertaking a study to look at why so many of its exams are appealed and litigated, and to learn more about noncompliance and the quality of its examinations. According to IRS, this study will identify why it loses recommended assessments and provide information on enforcement results by computing the amount of taxes lost. We believe this information would enhance IRS' evaluations of its enforcement programs and allocations of its resources.

In conclusion, we believe that IRS has made a good start with the gross tax gap and the net tax gap estimates. It is a good starting point to better tailor enforcement programs to reduce the gap. But we think that IRS needs to do more to evaluate and target its programs based on the major components in areas of noncompliance revealed. More in-depth analyses of noncompliance could create a more systematic basis for targeting enforcement resources. Regularly evaluating the program's success in reducing the gap could show whether IRS should redirect resources to other programs. Overall, we support IRS' more recent efforts to improve its enforcement programs and its information on noncompliance. We believe these initiatives have been needed for a long time, and we encourage IRS to complete them. Striving for improvement is crucial given a growing tax gap, a voluntary tax system, and a serious budget deficit.

That concludes my statement, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF PAUL L. POSNER, ASSOCIATE DIRECTOR
TAX POLICY AND ADMINISTRATION ISSUES
U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

We are pleased to testify on our work for you on the tax gap. As you know, IRS defines the gross tax gap as the difference between the amount of income tax that taxpayers owe and the amount they voluntarily pay for a calendar year. In 1988, IRS estimated the gross tax gap to be $84.9 billion for 1987 and projected that it would reach $113.7 billion by 1992. In this testimony, I will discuss more specifically the tax gap's size, our analysis of IRS' data on the tax gap, and IRS programs for reducing the tax gap, along with ideas for improving them.

Reducing the tax gap is an important challenge, given its potential negative effects on public confidence in the voluntary tax system and on the budget deficit. In its 1988 tax gap report, IRS noted that its enforcement programs annually bring in about $20 billion, which includes tax liabilities from past years. Clearly, more could be done to reduce the tax gap; but, the questions are how and with what resources.

Knowing the specific nature and causes of noncompliance could help IRS to better target its enforcement resources to reduce the gap. However, the tax gap estimate is aggregated by broad categories of taxpayers and does not provide sufficiently detailed information on who and what caused the noncompliance. As a result, IRS cannot evaluate how well its enforcement programs are reducing specific parts of the gap.

To gain insight into its nature and causes, you asked us to analyze major components of IRS' gross tax gap estimate for 1987.[1] Our work illustrates that IRS could further analyze the tax gap data to gain valuable insights on the types of noncompliant taxpayers and issues of noncompliance. Such insights could help IRS evaluate its ability to reduce pockets of the tax gap and identify other promising ways to use its enforcement resources.

THE TAX GAP IS LARGE AND GROWING

IRS' estimate depicts the gross tax gap as large and growing. In 1988, IRS reported that the tax gap was $84.9 billion for 1987 and projected that it will grow to $113.7 billion by 1992.

Individual and business taxpayers who do not voluntarily report taxes owed contribute to the tax gap. In 1987, according to IRS, they reported 83 percent of their tax liabilities. Because this rate has been fairly constant since 1973, IRS largely attributed the tax gap's growth to inflation and economic expansion, both of which raise income. IRS explained that higher income usually means more taxes owed, which means more unpaid taxes and a larger gross tax gap, even assuming a constant level of compliance.

Since 1979, IRS has estimated the gross tax gap three times. For the most part, IRS has based the estimates on the additional tax assessments that examiners recommended from their review of tax returns. The recommended assessments largely came from detailed examinations that IRS annually completes on some large corporations and that IRS periodically does on individuals and businesses under its Taxpayer Compliance Measurement Program (TCMP). TCMP measures compliance across random samples of various tax returns, such as those for individuals and small corporations. IRS views the amount of additional recommended tax as a measure of noncompliance when compared to the tax that was voluntarily paid.[2]

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[1] Tax Administration: Profiles of Major Components of the Tax Gap (GAO/GGD-90-53BR, Apr.4, 1990).

[2] IRS is now questioning whether recommended assessments that are lost through appeals and other ways should continue to be part of the gross tax gap.

ANALYSIS OF THE TAX GAP'S MAJOR COMPONENTS YIELDS INSIGHTS ON THE NATURE OF NONCOMPLIANCE

In its gross tax gap estimate, IRS aggregated the amount of noncompliance for over 20 types of components. At your request, we analyzed four major components: (1) sole proprietors, or self-employed workers who report business income and deductions on a Schedule C of their tax return; (2) informal suppliers, or self-employed workers--such as street vendors or "moonlighters"--who operate on a cash basis; (3) small corporations, or those with assets under $10 million; and (4) large corporations, or those with assets of $10 million or more. These components accounted for over half of the $84.9 billion tax gap in 1987.

For each component, we sought detailed information on the types of taxpayers and noncompliance that caused the tax gap, IRS programs to pursue this noncompliance, and ways IRS could better pursue it. Because IRS' tax gap report did not contain this information, we used a wide variety of IRS sources to get the best and most recent data on noncompliance and enforcement. The accuracy of the data depends on IRS' underlying examinations, analyses, and research, which we did not attempt to evaluate. Our analysis of these data led to the following insights on the four components.

-- Sole proprietors accounted for $16.6 billion, or about 20 percent, of the 1987 gross tax gap. IRS' examinations showed that they underpaid 23 percent of their tax liabilities, reflecting both unreported income and overstated deductions. Of the eight types of sole proprietors, those who underpaid the most taxes were service providers, producers of goods, and sellers of goods at fixed locations.[3]

-- Informal suppliers who did not report income accounted for $7.7 billion, or about 9 percent, of the tax gap. Because they operate in cash, their income is often neither documented nor subjected to third-party controls. Of 16 types of informal suppliers, those who accounted for the most noncompliance, according to a study done for IRS, were those who made home repairs, provided child care, or sold food at roadside stands.

-- Small corporations accounted for $5.2 billion, or about 6 percent, of the tax gap. Their noncompliance was about equally divided between unreported income and overstated deductions, such as for depreciation and repairs. Compliance ranged from 50 percent for those with $50,000 or less in assets to 90 percent for those with $5-10 million. Of nine types of small corporations, those in services and retail sales had the lowest compliance rates.

-- Large corporations accounted for $15.8 billion, or about 19 percent, of the tax gap. IRS attributed their noncompliance largely to improper accounting for reported income and deductions. For example, they misallocated income among foreign and domestic subsidiaries and misstated periods for depreciating or expensing assets. Of 27 types of industries, those with the most noncompliance were concentrated in petroleum or banking, based on IRS' 1988 examination results.

Research by IRS and others offers some reasons for noncompliance in the four components. First, noncompliance often occurs due to uncertainty about tax laws and a desire to increase profits. For example, noncompliance by sole proprietors and small corporations often resulted from confusion over their tax liabilities or from efforts to increase their profits by reducing tax liabilities. For large corporations, complex tax laws contributed to noncompliance, such as determining what expenses can be deducted under the research credit. Second, studies show that noncompliance is more prevalent and difficult to pursue when taxes are not withheld and information returns are not submitted. IRS' studies show that taxpayers report almost all wages and salaries, which are withheld, and interest and dividends, which are subject to information reporting. But, they report only 13 percent of informal supplier income, which is unlikely to be withheld or subject to information reporting.

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[3] IRS listed over 50 types of service providers (e.g., lawyers, accountants, doctors); almost 40 types of producers (e.g., construction, manufacturing, mining); and almost 50 types of fixed-location sellers (e.g., car dealers, grocers, jewelers).

ENHANCING IRS' APPROACH TO REDUCING THE TAX GAP

IRS generally does not design its major enforcement programs to specifically pursue components of the tax gap. With some limited exceptions, these programs address noncompliance in a general way by focusing on the types of tax returns rather than the type of noncompliance. As a result, these programs cannot be easily aligned with the tax gap components. Although IRS generally believes its programs are effective, the programs have limitations in reducing the tax gap.

For example, due to various reasons, IRS' rate for examining returns has steadily dropped to about 1 percent for individuals and under 2 percent for all corporations. However, because IRS has recently focused its examinations on cases with higher potential for generating tax revenue, IRS reports that its revenue yield has increased. For those returns that are examined, IRS officials have expressed concerns about whether examiners identify all noncompliance and recommend assessments that can withstand appeal. In 1989, IRS' Research Division estimated that individuals appeal about 63 percent of the amount of recommended assessments while large corporations appeal about 81 percent. It also estimated that IRS loses about 70 percent of the amount of recommended assessments that individuals and corporations appeal. Further, IRS estimates that income tax examinations only uncover about one-third of the unreported income due to inadequate documentation on what taxpayers earned.

IRS' document-matching program helps to disclose unreported income; it generated over $1.8 billion in recommended taxes and penalties in 1988. However, IRS cannot match all information returns to tax returns when information returns have erroneous information about who received the income. Nor does IRS have the resources to investigate all indications of unreported income that emerge from the matching. Further, IRS has not expanded the program to include payments to all types of businesses, such as corporations.

IRS recognizes these limits and has some initiatives to improve enforcement. For example, IRS has a special examination program to probe for unreported income by sole proprietors. IRS also has created a cross-index file to enable it to match information returns that had inadequate information on the identity of a sole proprietor.

The limitations in IRS' current approach and the size of the tax gap have prompted outside observers as well as IRS officials to offer ideas to improve IRS' enforcement. In 1989, for example, we recommended using information returns to identify employers who misclassify employees as independent contractors. Misclassification lowers federal revenues because taxes are not withheld and independent contractors usually are less compliant.[4]

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[4] Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 1989).

We also recommended that IRS develop a business document matching program to, among other things, identify corporations which have not reported income or filed tax returns.[5] IRS is studying the feasibility of implementing both recommendations. To capture taxes owed by informal suppliers, an IRS Assistant Commissioner suggested that state and local authorities verify that vendors and others seeking business licenses filed their federal tax returns.

While we have not evaluated all of the IRS initiatives and the proposals made, we believe that they warrant consideration and demonstrate the value of looking beyond IRS for both ideas and resources. However, given a limited budget, IRS needs to decide which ones would most cost-effectively reduce the tax gap. Further, we know from our past work that simply increasing enforcement resources will not lower the tax gap very quickly. In 1988, we reported that an attempt to hire more examiners did not produce revenues within the timeframes that Congress envisioned. IRS could not quickly hire the allotted number of examiners and then easily train and absorb them to do examinations without lowering the productivity of experienced revenue agents.[6] In essence, our work showed that not only does IRS need better information on resources and examination results, but that increasing IRS resources cannot be the sole response to quickly reverse a growing tax gap.

Instead, we believe a multi-faceted approach is needed to attack the many dimensions of noncompliance. Through this approach, IRS would build on its partnership with third parties to enhance its overall enforcement effort. Employers can help by withholding income taxes and depositing the taxes in a timely manner. They also can help by properly classifying workers as employees instead of as independent contractors. Business and government entities can help by submitting information returns to report required payments, which enables IRS to match them with tax returns to identify unreported income. Correctly reporting such payments reduces the cost of these matches. Representatives of taxpayers and tax practitioners can help by encouraging and assisting taxpayers to comply when they file their tax returns.

Even with such help, we believe that IRS cannot solely rely on enforcement to capture all noncompliance. Taxpayer assistance and education play important roles in encouraging compliance. IRS must continue, with the help of third parties, to assist taxpayers. IRS has been offering more workshops for small businesses and testing innovative ways to help small businesses to comply. IRS also must continue to educate taxpayers--including compliant ones--about their compliance responsibilities and enlist their support in improving compliance.

The success of any changes in IRS' enforcement will rest on the support of taxpayers and third parties. We recognize that changes may generate concerns. A program's start-up costs may exceed benefits in the short-term. New administrative or paperwork burdens may be opposed by IRS and others. Taxpayers' support may diminish when better enforcement, such as expanded information reporting, increases paperwork burdens along with the prices of goods and services from businesses and informal suppliers. Even so, we believe that the concerns can be addressed to minimize any burdens and that a lower tax gap is worth some additional costs and risks.

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[5] The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, Mar. 17, 1987).

[6] Tax Administration: Difficulties in Accurately Estimating Tax Examination Yield, GAO/GGD-88-119, August 1988.

IRS CAN ANALYZE ITS TAX GAP DATA TO BETTER TARGET ENFORCEMENT RESOURCES

The study we did for you suggests that IRS could further analyze its tax gap data to more specifically pinpoint the types of taxpayers and noncompliance giving rise to the tax gap. Knowing more about noncompliance could allow IRS to target enforcement resources on troublesome pockets of the tax gap that can be cost-effectively pursued.

We believe that such knowledge also could provide IRS with a better basis to evaluate the effectiveness of its enforcement programs, as well as proposals that offer promise for reducing the tax gap. Although IRS estimates the total revenues produced by its enforcement programs, it does not have sufficient data to track the issues most responsible for the tax gap and whether these programs reduce noncompliance among taxpayers. As a result, IRS cannot link the enforcement programs' results to the tax gap components for any specific tax year.

For example, with the exception of TCMP, IRS does not track the issues of noncompliance raised through its examinations. Without such tracking, it is difficult for IRS to evaluate whether its examinations successfully deal with the major issues causing the tax gap for such components as large corporations or sole proprietorships. The lack of a system to track issues, as well as the recommended assessments, from examinations through appeals and ultimately to collection also has complicated IRS' efforts to better understand problems with its current programs, such as why it loses an estimated 70 percent of appealed assessments.

IRS recognizes that it needs to know more about noncompliance and its enforcement results. For example, to detect noncompliance early, IRS now has teams of employees who are reviewing random samples of tax returns at all service centers. IRS' goal is to identify trends in noncompliance as returns are filed rather than wait 3 years or more for the results of examinations or special studies. IRS believes that this effort eventually will highlight issues that need immediate attention.

Regarding the need for more information about enforcement results, IRS published a report in 1989 on its study of various problems and ongoing improvements in estimating enforcement revenue. For example, IRS is using more recent data and is revising assumptions on how much recommended tax gets assessed and collected. The report also outlined future improvements such as (1) compiling actual revenue by type of tax and year of the tax liability and (2) developing a system to capture the flow of enforcement revenue across functions, such as the Examination and Collection Divisions.

Further, IRS is studying cases that are appealed and litigated to learn more about noncompliance and enforcement results. According to IRS, this study will identify why it loses recommended assessments, such as the types of noncompliance that cause the most problems, and provide information on enforcement results by computing the amount of taxes lost. In turn, this information could enhance IRS' evaluations of its programs and allocations of its resources in deciding how to reduce the gap.

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In conclusion, we believe that IRS' estimate of the gross tax gap can be a good starting point for better tailoring enforcement programs to reduce the gap. The tax gap's size and growth suggest that IRS needs to do more to evaluate and target its programs based on the major areas of noncompliance. More in-depth analyses of noncompliance by tax gap component could create a more systematic basis for targeting enforcement resources.

Regularly evaluating enforcement programs' success in reducing the tax gap could show whether IRS should redirect resources to other programs or initiatives.

Overall, we support IRS' efforts to improve its enforcement programs and its information on noncompliance. We believe these initiatives have been needed for a long time, and we encourage IRS to complete them. Striving for improvement is crucial given a growing tax gap, a voluntary tax system, and a serious budget deficit.

That ends my prepared statement. I would be happy to answer any questions.

Chairman PICKLE. Thank you, Mr. Posner. I want to commend you for this publication "Tax Administration Profiles of Major Components of the Tax Gap." It is the first thorough analysis of some of the main profiles of those who are not paying their taxes. It is a breakdown that we have asked you to make, and you have made a good study. I commend this to the members, and to the Members of Congress, to study this report as we move forward on this question.

Now, Mr. Posner, I understood you were going to make a summary statement, but you have delivered the full load to us this morning. I regret that we didn't understand that because I would like you to have presented it slowly and thoroughly and carefully so we could understand everything that was being said. But we do have the report, and it is a good one. And we will be making reference to it now as we proceed today. So I want to thank you.

Now, I think my first question would be of a general nature. Let me proceed with that. Mr. Commissioner, we have said that the tax gap now exceeds $100 billion a year, and that that's a generally conceded figure. Do you dispute that or is that in general agreement with your estimates?

Mr. GOLDBERG. Mr. Chairman, I think $100 billion is a good mark to be talking at, yes, sir.

Chairman PICKLE. And GAO is in general agreement with that.

Mr. POSNER. For the income tax side of it, yes.

Chairman PICKLE. All right. Now, this tax gap estimate is limited to the Federal income tax, and income tax primarily. I want to ask you, can you tell me how much money is actually lost from illegal activities? Can you tell me, Commissioner, how much money we estimate we are losing from illegal activities; that is, drugs; how much we are losing in the area of employment taxes; how much we are losing in the area of excise taxes or gift and estate taxes? Can you give me a breakdown on those figures?

Mr. GOLDBERG. Mr. Chairman, in response to this committee's request, we are preparing a tax gap estimate covering the illegal sector and expect——

Chairman PICKLE. Commissioner Goldberg, a little bit louder and into the microphone.

Mr. GOLDBERG. In response to the committee's request, we are preparing an illegal sector tax gap report that will be released this summer. We are also preparing a report dealing with employment taxes. It is substantially finished and should be out this summer. We have recently initiated a study of the excise tax area which we hope to complete this year. So those three areas are of great importance, and we are focusing our attention on them.

Chairman PICKLE. Well, I am glad you are preparing that. Now, 2 years ago, Commissioner—not in your time, but the previous administration—the subcommittee had asked the Internal Revenue Service whether they would use that tax gap figure they had then as just a starting point, and whether we could measure these other categories. Are you saying to us that you can give me, you hope to give me an estimate of these illegal activities by this summer?

Mr. GOLDBERG. Yes, sir. The estimates by their nature will be very rough, but we will have a report with estimates this summer.

Chairman Pickle. All right. Now, if you are going to have it very rough, does that mean that you are attempting to measure it in some way?

Mr. Goldberg. Go ahead, John.

Mr. Johnson. We are relying, sir, on a good deal of third-party information; for example, State and local enforcement agencies, DEA, et cetera, as well as material that we collect by ourselves.

Chairman Pickle. Whatever methods you use, you hope to give us a general estimate by this summer.

Mr. Johnson. Yes, sir.

Chairman Pickle. Well, now, 2 years ago, we wanted this comprehensive review. Does the report you are going to give us mean it is the answer to the request we made of you 2 years ago?

Mr. Johnson. Yes, sir.

Chairman Pickle. Now, why has it taken 2 years' time to make these estimates?

Mr. Johnson. Particularly in the illegal area, sir, the data are almost nonexistent or very soft, subject to a great deal of variability. We have compiled data, worked with other agencies, and discussed it with them. I think when we come forward with the report for you, it will be the best possible report that could be made.

Chairman Pickle. Well, the GAO looked into this and came up with some general figures in less short a time. You had 2 years, and now you are going to take a few more months. GAO, have you got any figures in these various fields?

Mr. Posner. We haven't looked at illegal source income. The last tax gap report that IRS did—I believe it was for tax year 1981 and was issued in 1983—indicated about $9 billion in unreported taxes due to illegal source income.

Chairman Pickle. Well, the IRS said they are going to make a report on their net tax gap figures as compared, I presume, to the gross tax gap. And you have been looking at that for some time. Now IRS, you have made your report to the OMB and to the Treasury about your tax gap figure. Why has it taken the Internal Revenue Service so long to issue this net tax gap report?

Mr. Johnson. Sir, principally because at the time we finished the gross tax gap report we had detected—and we were assisted in this detection by the General Accounting Office—that our previous estimates for realization of revenue from enforcement activities was overstated. One of the matters, for example, the Commissioner referred to earlier: that the number of cases from recommendation status in audit going on to appeals had risen rather sharply, and the percentage of recovery on those cases had dropped. We took a very, very extensive look at this—I think you are familiar with it. It is a report called the "Evaluation of the IRS System of Projecting Enforcement Revenues." We felt that was a vital first component before we moved to issue the net tax gap report. That was finished and published in November of 1989. We then used those findings to modify and improve the net tax gap report, which we are releasing today.

Chairman Pickle. Well, the Commissioner makes some suggestions about improving our tax system; increased audits, increased enforcement. In two or three instances you have said it may be well that we increase our audits and it may be well that we pick up our enforcement activities. Why is it that the Internal Revenue Service has so sparingly used its criminal investigation resources?

Mr. Johnson. Charly, do you want to comment on that?

Mr. Brennan. In terms of investigations?

Chairman Pickle. Of alleged cases of noncompliance and prosecutions.

Mr. Goldberg. Mr. Chairman, as you know, from a very general standpoint, the Internal Revenue Service has been living under a hiring freeze for the last 2 years, and that has made it difficult to expand anything. I think within this criminal enforcement context, we are devoting a significantly increased portion of our resources to organized crime and to illegal drug activities. And with a fixed budget, as we spend more time on that side of the criminal enforcement effort, we necessarily spend less time in the area of unreported legal sector income. So that shift in resources has taken place over the last decade.

Chairman Pickle. Well, Commissioner, I want to see your figures about the amount of funds or the approach you are taking on the prosecution of these cases. You say you have increased those activities. It seems to me like you have increased them in some areas against individuals. But you haven't increased your activity in the criminal prosecution of corporations. If you have got figures to the contrary, I want to see them.

Mr. Goldberg. Mr. Chairman, they are not to the contrary. The trend is quite striking, as a matter of fact, and we would be happy to provide that information for the record. And it supports exactly what you are saying.

[The information follows:]

CRIMINAL INVESTIGATION ACTIVITY—INDIVIDUALS VERSUS CORPORATIONS

Criminal Investigation initiates very few cases on corporations. Normally, cases are investigated on corporations only until a responsible individual can be identified.

ALL CASES VERSUS CORPORATE CASES, FISCAL YEAR 1984 THROUGH FISCAL YEAR 1989

[Excludes fiscal year 1986, for which data is unavailable]

Fiscal year	Initiated		Prosecutions recommended	
	Total	Corporate only	Total	Corporate only
1984	6,191	132	2,990	60
1985	6,065	137	3,234	72
1986	5,861	NA	3,524	NA
1987	5,511	96	3,526	91
1988	4,899	101	3,044	79
1989	5,417	112	3,242	78

NA—Not available

Chairman Pickle. Can you tell me of this $100 billion that is listed as the tax gap, how much of that do you expect to collect?

Mr. Goldberg. We expect to collect—given existing activities—between 20 and 25 percent of it. Now, if we pursue the strategies that we have laid out, then I believe we could collect a significantly higher percentage of that amount in the years ahead.

Chairman Pickle. What do you mean by significant?

Mr. GOLDBERG. Well, we are getting 25 percent now, I think that we could get up to 30, 40 or 45 percent of it.

Chairman PICKLE. If I understood you, you said, you hope to collect 45 percent of it?

Mr. GOLDBERG. We expect, given our current resources and the current state of the tax system, that we will collect between 20 and 25 percent. If we pursue the strategies that we have laid out in our testimony, that GAO and others have described, and that I believe this committee itself supports, and if we are willing to make that investment for the future, we will collect a lot more than 25 percent.

Now, will that be 40 percent, or 50 percent? Yes, I think that is a reasonable range.

Chairman PICKLE. Will you request more money for audits?

Mr. GOLDBERG. Mr. Chairman, the administration's budget request for 1991 requests an increase in our audit activity. I would like to give you some statistics on this point. It is very important to follow.

We can only grow so fast. As the GAO has correctly pointed out and I applaud their effort in this area, it takes time to train and develop the abilities of our agents to deal with these very hard issues. If we grow at the rate the President's budget proposes in 1991, and we grow at that rate every year until the year 2000—so we invest in that increase every year until the year 2000—our audit coverage will be back up to 2 percent. It is going to take us 10 years to get back to where we were in 1980.

As to the questions about the fact that there is not an immediate payoff, Mr. Chairman, we need to make this investment and we need to start right now. And it is——

Chairman PICKLE. Well, you say that it will take you 10 years to get back to where you were in 1980, why have we lost ground? Your report indicates to us that you are really making progress, and we are appealing for the cooperation of the American taxpayer, and yet, you say we have lost ground ever since 1980. What has happened?

Mr. GOLDBERG. Mr. Chairman, I believe that we have made enormous progress. I think that we are doing a lot better with what we have, but I think the budget process——

Chairman PICKLE. Well, you say you are doing a lot better, Mr. Commissioner, but the GAO simply starts off by saying, the tax gap is growing; it is increasing. Do you disagree with that?

Mr. GOLDBERG. In dollar terms, I think that is correct, Mr. Chairman. The tax gap in percentage terms, I believe is going down. I believe as a result of the 1986 Tax Act compliance by the American taxpayer is better today than it was 5 years ago, in percentage terms. But if our revenues increase, and our revenues have gone from $600 billion to $1 trillion, and if the voluntary compliance percentage stays the same, then the tax gap is going to go up because it is against a larger base.

Chairman PICKLE. Commissioner, I want to come back to that. But what you are saying, it just seems to me to be contrary to what the public thinks and what most of the members, I think of this committee feel, that we have got a very serious problem. The gap is growing and we have got to take steps to close it, if we are going to protect the attitude of the honest taxpayer.

And that is a serious problem and I do not think that we ought to just say, well we are doing a lot better. But we will come back to that.

Let me recognize some of the other members at this point.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I would like to follow up on that topic, because it seems to me that Members of Congress and this committee may have led the public into thinking that the tax gap is increasing dramatically. When the figures that I see say that it has been holding somewhat steady.

As the tax collections increase and have increased dramatically over the last few years, the percentage of tax gap is about the same.

Now, Mr. Commissioner, first of all I forgot to thank you for your presentation. It was interesting and I am glad that you are all here. I would like to have your views on that point. Whether the percentage of tax gap is holding steady or is actually improving somewhat under the present status?

Mr. GOLDBERG. You are correct, Mr. Schulze, we believe it is holding steady and maybe even declining slightly.

Mr. SCHULZE. Well, there are Members of Congress who go around and say, oh, the tax gap is growing enormously. It is somewhat misleading, is that correct? Because it may be increasing in dollars, but the rate of compliance has been holding fairly steady.

Mr. GOLDBERG. We have a remarkably compliant taxpaying public, but I share the chairman's concerns. It is a terribly serious problem.

Mr. SCHULZE. Do not get me wrong, as I said in my opening statement, I think it should be a source of concern. But I do not think that Members of Congress should go around and try to make people get more excited and discontent with the IRS than they already are, by saying that the IRS is being cheated.

It is a source of concern and we want to get the dollars that are due. But if it is holding steady, then perhaps we should be somewhat more introspective and say, what are we doing on the Ways and Means Committee, or the Senate Finance Committee, or as Congress to make this so complex that it is difficult for the average citizen to comply?

Now, one other thought along that same line. How does our compliance rate compare to other nations? How do we stack up versus our major trade competitors or the European countries or other nations who have somewhat similar tax structures?

Mr. GOLDBERG. We find ourselves far ahead of our foreign colleagues, because none of them have TCMP data and they do not do compliance studies. But having spent a great deal of time with our colleagues from the United Kingdom, Germany, France, Japan, and Australia, I think the general sense is that we have the finest functioning system in the world.

Mr. SCHULZE. Is it not true that many European countries even have implemented tax forms which are much more forceful in compliance at each stage of the processing, for instance, because of noncompliance? That noncompliance is so great in European countries that the nations devise their tax process so that it is sort of forced compliance?

Mr. GOLDBERG. That is consistent with our information. I do not know if GAO has——

Mr. POSNER. We have not studied the international situation.

Mr. SCHULZE. OK.

I forget whether it was Mr. Posner, or Mr. Goldberg who talked about small business' noncompliance.

Having spent a couple of decades as a small businessman, I would like somebody to point out to me the advantage to a small businessman of hiding income? My struggle as a small businessman was to get my credit rating as high as I could get it so that I could leverage my purchases and so forth. The better my credit rating the more I could buy, the more I could expand my business. I wanted every cent of sales and everything to show on my financial statement.

The big growth in small businesses, it seems to me, was where accounting firms come around and say, we have a computer accounting process so that we are more accurate, we are more rapid, and we can give you a truer picture of your business now.

Perhaps I have a distorted view of the small business community of America and if I do, I want you to straighten me out, but my constant battle was to increase sales, increase income and show it on my credit statement.

Now, I would like to have the opposing view if there is one?

Mr. POSNER. Well, I could start off on this. I do not necessarily think that the tax gap means that people are intentionally or criminally or fraudulently hiding income. Some of it is merely due to confusion, lack of knowledge of the Tax Code, and the complexity of the Tax Code. That is why IRS, for example, has workshops for people who are starting small businesses to inform them of their tax obligations. IRS is putting out an automatic calendar that is going to let them know about key filing dates and that kind of thing.

So I think that when we talk about targeting the tax gap, we are not just talking about targeting people for enforcement. We also are talking about targeting education efforts and information efforts as well. Having said that, we simply do not know what part of it is intentional. It is a very competitive world out there in the small business sector and taxes are a big part of profit and loss. So it is unclear what part is intentional.

Mr. SCHULZE. Well, with respect to these small businessmen, I believe someone said most of them have receipts under $100,000 and a lot of them under $50,000. I do not understand the benefit, unless they are just out-and-out crooks—and I guess there is a percentage of that—I do not understand the benefit of hiding this income.

If it is just to avoid taxes, most small businesses expenses are so great that they need that income and they want to show that income. They do not make a lot of money anyway, at least those under $100,000, they are just scratching to get by.

I just cannot see the advantage and if there is one, I would like to know it so that I can change my mental attitude. So what advantage would it be, unless they are out-and-out crooks, for them to hide this income?

Mr. POSNER. Well, the financial advantage would be lower taxes, but whether they are hiding it from IRS——

Mr. SCHULZE. It really would not be a lot of taxes though, would it?

Mr. POSNER. Well——

Mr. DORGAN. Would the gentleman yield on that point?

Mr. SCHULZE. Sure.

Mr. DORGAN. If you are talking about income here, the other approach that results in the tax gap is the overstating of expenses. And that is a very substantial part of——

Mr. SCHULZE. That was what I was going to get to next to see whether that——

Mr. DORGAN. Because that combines an entirely different kind of motivation in terms of what you are able to show your creditors and others and still able to minimize your tax obligation.

Mr. SCHULZE. Still, if you overstate your expenses, the bottom line on your credit report at the end of the year is a poorer credit report.

Mr. DORGAN. If the gentleman would yield?

As you know, what you report to your banker has nothing at all to do with what you report to the tax man and that has always been the problem.

Mr. SCHULZE. Well, no, not necessarily. But you know, I do not know how many years you spent in business but I spent——

Mr. DORGAN. Enough to understand that.

Mr. SCHULZE. How many years was that?

Chairman PICKLE. Your time has not expired yet.

Mr. SCHULZE. No, I am moving along as rapidly as I can, Mr. Chairman.

One other point. The inference or it seems to be stated that child care income is an area where there is a lot of avoidance in tax payment.

Is this from large, formal child care operations, or is this from the grandmother-type of operation, family-type, neighborhood-type child care operation?

Mr. GILLEN. Mr. Schulze, this is not involving babysitters and people who are in the families. That was excluded from IRS' tax gap estimate which was based on a University of Michigan study. But it does involve——

Mr. SCHULZE. I can hardly hear you, Mr. Gillen.

Mr. GILLEN. What it does involve is people who are in the business of providing child care; as you know, the tax law changed to where those EIN's or SSN's are now required to be reported, if someone is claiming a child care deduction. So IRS is hopeful that this will help in the reporting.

Mr. SCHULZE. So it is not the small, informal child care operation?

Mr. GILLEN. Not exclusively, no.

Mr. SCHULZE. Then it is the small, informal?

Mr. GILLEN. Well, it is going to include some people who may care for a dozen or so people's children during the day. But it does not really including a grandmother or a babysitter who is providing the care, unless there is an expense involved that would be a part of the child care deduction.

Mr. SCHULZE. Well, there sometimes is grandmothers or members of the family in poorer neighborhoods, where a grandmother will take in not only her grandchildren but a couple of others, as well.

I just wonder whether it would not be better in child care situations to say that any income under $10,000 or $12,000 a year is exempt. Because sometimes I can understand why they would do this and say, I will take care of the child and pay me in cash and so forth on a small basis.

It seems to me that we should perhaps encourage that somehow, instead of discouraging it, because if we clamp down on them then what they are going to do is to say, OK, we will keep the child but we have got to fill out these forms and we have got to pay the tax so that we are going to charge you more to keep the children.

The thought just came to me, would it not be better to exempt that income somehow, if it was a relatively small amount? Would it give you less compliance problems, make it easier for audits and really help the economy?

Mr. MURPHY. Congressman Schulze, I certainly do not disagree with what you just said, and that ought to be considered. But I think in response to your question, I think we have got a mix of informal babysitting, as well as agencies that provide it. So the gap includes both.

So I think you have got to look at both sides of it.

Mr. SCHULZE. I am not talking about the formal agencies. I am talking about the informal portion of that equation and it just seems to me that it might be worthwhile looking at.

Mr. GOLDBERG. Mr. Schulze, as a general proposition, I think the wage earners, the working men and women of this country, are paying virtually what they owe. There are folks at the other end of the economy who are barely scraping by.

We should not be spending our time in those areas. We are talking about companies, and that is why our schedule C effort is gross receipts over $100,000. Our interest is in big dollars and sophisticated taxpayers.

We need to be sure we are not going after working men and women and the folks scraping to get by. I share your view on that 100 percent.

Mr. SCHULZE. Thank you.

Chairman PICKLE. The Chair is going to recognize Mr. Dorgan.

Let me say this, Mr. Schulze, now, the purpose of our hearing is to try and get facts and see what we can do about them. We have to admit that our noncompliance rate fluctuates between 20 and 23 percent. But it is over the 20 percent mark. Now, that is an alarming amount and an alarming admission. I do not think that we ought to just pass it off as if it is not a real concern.

We have to admit that our audit rate has gone down, down, down, below 1 percent. And we have to seriously start to think. Now, must we have a mandatory compulsory level for audits beyond which you cannot go? We have not asked for enough audits. We have not asked for enough enforcement. We have asked for less this next year. We have got to admit that. That is not your problem, Mr. Commissioner. It is the administration's and the Congress' problem.

We have asked for less money for taxpayer services. We went up and then we went down a little. Now, these are facts and we just cannot ignore them. And we just cannot say that most people are honest about it. The fact of the matter is that when those rates of noncompliance are that high, I think we, as a committee, have got to look at them.

And I think the study from the GAO is going to be helpful and you, Mr. Commissioner, must admit that in most of these areas we have got to make an improvement. I want to make those improvements. And I do not want to start out here with a big hatchet and say, we are going to chop everybody up if they are not paying their taxes.

But when we know from these four categories that there is a great shortfall, and that we have got a tax gap of $100 billion, then we cannot accept that, and say, well we have got a serious problem and we ought not to be too concerned about it.

I just wanted to lay those out as cold facts and to try to set, at least what we hope to be, the committee's attitude.

Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Chairman, let me clear up a couple of issues I think, with respect to Mr. Schulze's discussion. I was not sure where Mr. Schulze was going with his line of questioning, because when Mr. Goldberg indicated that it will take us to the year 2000 to get back to where we were in the year 1980, it seems to me that that suggests there is a pretty serious problem.

Almost never will you find the same representations given to a banker or a stockholder that are given to the Internal Revenue Service, or the tax person. That was the point I was trying to make to Mr. Schulze, and I expect you understand that.

The point here is not the rule. The rule is that most people file and comply. They are honest and do not cheat, and pay what they owe. The question here is the exception. Mr. Schulze was asking about the rule. I agree with him. As a rule, people in this country pay the taxes they are required to pay. They are honest and we rely on them. And thank God they are honest and do own up.

Part of our problem in the tax gap is this: I've dug out the income tax return from 1930. Here it is. It is this sheet. This is 1930's income tax return. And here are the instructions, two pages.

Now, I did not have enough porters to bring this year's return and instructions to the committee—I am not sure we have room for it all here—but this is part of the problem. The incredible complexity of our system

You wonder how the American people comply as well as they do, as complex as our system has gotten compared to what it used to be.

But let us deal with this exception. The chairman is dead right when he says, if you have got 20 or 25 percent slipping through the cracks, and if we were an American business and we were running the business as a CEO, a good conservative CEO Mr. Schulze, you darn sure would call your best people in and say, look, we have got 20 percent of the revenue falling through the cracks here. Let's try and figure out where it is and how we get it back. That is the way for us to do business.

Now, I understand that we will not get all of this tax gap money back because some of it comes in such small amounts and would be so difficult. The systems necessary to keep track of it would be so difficult, and we would not want to do that. But a substantial amount of it comes in large chunks. And I am going to talk about several parts of that today, and it ought to be easy to get that money. There's no excuse for us not to get that money.

And Mr. Schulze, I think you were not listening when I indicated that the Commissioner said it will take us to the year 2000 to get back to where we were in 1980. That suggests to me a very serious compliance problem, and one that we have to assist the Commissioner in solving.

Now, I would like to ask some specific questions, because I think that a country that is up to its neck in debt and yearly deficits ought to try to figure out how you get money from the deadbeats—those who are not paying their taxes—before you try and figure out how you increase the taxes on those who already pay. We know there is $100 billion here from folks that do not now pay and some of it is in very large chunks. How do we get that before we go to the honest folks and say, we are going to increase your tax burden, because these folks over here have decided not to pay?

Let me ask you some questions about that because on page 5 of your testimony I was struck again by the drama of these numbers. Sole proprietors, informal suppliers: in 1978 we audited 3 percent, 3.09 percent. That has dropped by 30 percent. We now audit only 2 percent. A 30-percent reduction in audit coverage in that area. That is the doctors and lawyers and others, the sole proprietors, and informal suppliers.

Large corporations: We used to audit 47.8 percent in 1978 and now it is 25.5 percent, almost a 50-percent drop in audit coverage. Now, Mr. Goldberg, I have obtained the revenue agents and examiners and auditors, the numbers that are employed down at the IRS, and I am trying to understand the reason for the substantial drop in audit coverage related to the number of examiners and agents we have. And I am not sure I understand exactly why that has occurred.

In 1981, for example, we had 13,200 revenue agents and this year we are supposed to have roughly 16,500 revenue agents.

If we have 20 percent more revenue agents than we did 8 or 10 years ago, why has the audit coverage dropped 25 or 40 percent? I understand there are more returns filed but that would not account for that substantial drop in coverage. Could you address that question, Mr. Commissioner, with the increase in the number of agents, although it has not been a dramatic increase, why the dramatic drop in audit coverage?

Mr. **Goldberg**. Mr. Dorgan, there are a number of reasons. One is that the growth in returns filed over the last 10 years is very dramatic, and I think if you just look at the numbers you will find that explains some significant portion of it.

Second, during the 1980's this agency diverted or expended an enormous portion of its examination effort in the tax shelter area. That was proper. That was the biggest threat the system faced during that period of time. Now, we are still working through that tax shelter inventory. So when you look at the audit coverage figures for the three categories showing up on page 5 of my statement, that does not include tax shelters.

So it is a combination of the growth, which has been very real, and a focusing of our resources in other areas where we felt there was a more clear and present set of problems.

Mr. DORGAN. Now, the tax shelters came principally from the ability to convert income from ordinary to capital gains? I mean——

Mr. GOLDBERG. No, I think the primary reason was the ability to achieve unlimited and——

Mr. DORGAN. Do not get ahead of me now.

The inability to what?

Mr. GOLDBERG. The ability to achieve unlimited deferral. In other words, the deductions and the credits in the tax shelter area which fueled that industry.

Mr. DORGAN. Well, my general notion, both from an academic and a practical perspective, has been the conversion of income to lower rates is much of what fuels the tax shelter industry. Now, I will not bother you today, because I think I understand your answer. But if you are saying that one of our major problems has been the tax shelter industry and the need to audit that and the drain of resources to deal with that, the logical next question is: in testimony not too long ago, you were suggesting it would be fine to go back to the old capital gains differential and that would not cause you any serious heartache. That seems at odds with the facts in my judgment.

But let me ask you this. I would like to try to understand precisely what kind of resources you are devoting to the war on drugs and organized crime that used to be devoted to ordinary tax compliance issues? Could you give us some general understanding of what kind of resources are committed to that down at the Service?

Mr. BRENNAN. I cannot give you specific figures, but it has gone up over the past 3 or 4 years, particularly in the last 5 years, I would say, in criminal investigation. There may have been an increase in our examination area, but I would have to provide the specific figures for the record.

Mr. DORGAN. But criminal investigations——

Mr. GOLDBERG. It has been a dramatic shift and we will be happy to provide you with that information.

[The information follows:]

STAFF YEARS DEVOTED TO NARCOTICS AND ORGANIZED CRIME CASES VERSUS REGULAR PROGRAMS

Fiscal year	Criminal investigation				Examination	
	General enforcement program	All special enforcement programs [1]	Narcotics only	Total	Narcotics/organized crime	Total
1985	1,693	1,541	840	3,234	326	14,076
1986	1,736	1,788	956	3,524	372	13,723
1987	1,691	1,835	996	3,526	440	14,984
1988	1,383	1,661	876	3,044	341	16,534
1989	1,348	1,894	1,176	3,242	298	16,246

[1] Includes narcotics and organized crime.

Mr. DORGAN. The dramatic shift occurs without significant new resources coming to you so that you take resources away from what otherwise would be used to audit large corporations, sole proprietorships and others, is that correct?

Mr. BRENNAN. The dramatic shift has been particularly visible in our criminal investigation area. I am talking about special agents there. In terms of revenue agents that do our civil examinations, we have not taken resources out of our large corporate program to do that, but some has come out of pretty much all other areas, including individuals.

Mr. DORGAN. But your criminal prosecutions have decreased dramatically in the tax area. Is that because you have drained those resources into other areas?

Mr. BRENNAN. Our prosecutions have shifted, have decreased in what we refer to as general enforcement, if you will.

Mr. DORGAN. Dramatically, less than half, from our numbers. Let me give you some numbers: 2,898 criminal prosecutions in 1978; 1,383 in 1988.

Now, it takes a substantial amount of effort by revenue agents to get to the point where you move this up through your system—and I have always thought the system was a rather muscle-bound system down there, with Justice—to actually achieve criminal prosecutions.

But there has been a dramatic decrease in criminal prosecutions in the tax area, at least based on the information I have. Is that at odds with your information?

Mr. BRENNAN. I could not catch your numbers, sir. But my numbers are in terms of roughly 1,700 staff years we were devoting to prosecution recommendations in what we call our general program, and that has decreased from nearly 1,700 in fiscal year 1985 down to about 1,300 in round figures.

Mr. DORGAN. And my numbers are that we had 2,898 prosecutions in 1978 and that will be 1,383 in 1988 was——

Mr. BRENNAN. I only have data here back to 1980, sir. I think that the figures that you have may be total prosecutions. And what I am saying is that we break it down between general enforcement on regular tax work, and special enforcement.

Mr. DORGAN. Do you agree that there has been a substantial decrease in the number of criminal prosecutions in the tax area in recent years?

Mr. BRENNAN. Well, if you just consider the tax area?

Mr. DORGAN. Yes.

Mr. BRENNAN. For the normal tax work and not drug work, the answer would be, yes.

Mr. DORGAN. And the reasons for that?

Mr. BRENNAN. We have shifted into other areas, the drug area and money laundering, for example.

Mr. DORGAN. And so because resources are shifted over to the drug enforcement area—money laundering, drug-related issues, the normal tax compliance criminal prosecution area is suffering.

And the reason that is important is, for example, our subcommittee has information from various sources. We call the IRS and say, look, here is some tax fraud going on—this is a fellow in Timbuktu, and he says, Mr. IRS Agent, here is some tax fraud and it is big money. Normally one would expect it to be A, investigated; and B, prosecuted.

From the information that we have gotten—at least on a number of cases that have been given to us—they were not even investigated, let alone, prosecuted. And one wonders with these numbers, if they were investigated, whether you would have the resources to prosecute them?

And if people out there understand that the Internal Revenue Service is way too busy over here on the drug issue—we can cheat and nothing is ever going to happen to us—if they understand that, there are those exceptions out there that will cheat and cheat in the area of some big dollars.

And that is why criminal prosecutions for those who exhibit criminal behavior and want to cheat, it seems to me, is an important element of tax compliance.

Mr. GOLDBERG. Mr. Dorgan, just a couple of comments.

One, I think it is very important to point out that IRS efforts in the money laundering context get at unreported income in the legal sector. And we view our money laundering efforts as very important at getting at the cash economy in the legal sector.

I think the second point is that the Internal Revenue Service plays a unique role and makes a unique contribution to this nation's war on drugs. Our special agents are the best in the business at dealing with financial crimes.

And so what I hear you saying is not that we should not continue to pursue that avenue, but that our criminal enforcement in the kind of areas you are talking about needs to be beefed up.

And that is why you need balance in the program, and we need to restore some of our efforts on the traditional income tax side as well as continuing to deal with money laundering and the drug crimes.

Mr. DORGAN. That is exactly what I am saying. But you do not have the resources to do that. And the President, in the campaign, said that those of us who suggest better enforcement are suggesting putting an auditor in every kitchen, which of course, was ridiculous.

What we are talking about is adequately enforcing our tax laws so that those who are honest have some understanding that those who want to cheat are going to be caught and required to pay their same obligation for our Government.

Mr. GOLDBERG. But, Mr. Dorgan, I think as the chairman pointed out, we ought to talk in facts. And this administration has come forward with a very appropriate budget for the Internal Revenue Service for 1991 that does turn around the decline in audit coverage, does turn around the decline in service we are providing taxpayers.

That ball is in the Congress' court right now, Mr. Dorgan.

Mr. DORGAN. Except that every Commissioner has told us that in every appearance since I have been on the committee since 1983. And, as I look at what has happened since 1983, and before I came on the committee prior to that, it is very alarming.

It does not matter what people say and what they send up here. What matters is, do they have a commitment to follow through and to support the agency?

The issue is drugs these days and I do not minimize that. We have a very serious problem in the drug area. But in order to respond to that problem, you have got to be willing to commit the resources to it. If we are going to say to the Internal Revenue Service, well, your audit coverage has dropped 50 percent for corporations and 30 percent for sole proprietorships and we have nearly $30 billion in uncollected money—some of it in big chunks from those areas—you take your resources and go over here and deal with the drug issue, and we are not going to replace them, then that is a very serious problem.

Mr. **Goldberg**. I agree and we are not doing that. And I want to emphasize that the 1991 budget proposes funding the amount of growth in our examination function that we can reasonably absorb. And, again, I think the GAO report that we talked about pointed to the problem of absorbing revenue agents and the very sudden growth in the examination function in the mid-1980's, and how we could not swallow all of that at once. I think that all of us paid the price for that.

We need to go through a stable, steady pattern of growth. I think we need to grow better. I think, as a result of GAO's effort, we are changing the way that we train our revenue agents, so that we are not taking productive folks off the line. We are doing a lot better, but I think that we have got to grow. And the budget asks for an increase of about 750 to 1,000 staff years. That is only 750 to 1,000 additional bodies for 1991. And I think we need them.

Mr. **Dorgan**. Well, then give me an example. What would you anticipate doing in the area of compliance in large corporations where we have $15-or-so billion identified in this tax gap? What would we expect in the next year or so to see to try and improve the nearly 50 percent decrease in audit coverage for those corporations?

Mr. **Goldberg**. Mr. Dorgan, I think in the large case area, we are investing a lot of resources. My personal judgment is that the biggest challenges in the large case area are the quality of the efforts we make in terms of greater use of outside experts and more focused issue identification. I think the quality of the effort there is our number 1 priority.

And, as I indicated, we have received a report recommending a number of very significant changes in the entire way we deal with the large corporate program. We have not made any decisions on it. I would be happy to share that with you and would appreciate your views. But in that particular segment, I do not believe that it is so much a resource question as it is a quality question. I think in some of these other areas, when you look at the decline in the small corporate area, when you look at the sole proprietor and informal supply area, it is purely and simply a question of resources.

We have local programs dealing with certain types of informal suppliers where we are getting yields that are two and three times our yields in any other program. We need the money to expand the effort and we are asking for it.

Mr. **Dorgan**. Mr. Chairman, for Mr. Schulze's benefit, when I was in graduate school I went over to the home of an acquaintance of mine and he was at his card table. And he was doing his income tax return. And he had gotten all of his canceled checks for the year and was going through his canceled checks and he was putting them in piles. And he was, you know, this is for clothing, this is for gasoline, they were all going into the same pile to his left.

And I said, what is that pile on your left? Those are my tax deductions he said. I said you cannot deduct your suit. You are a wage-earner downtown. He said, why do you think I buy the suit; to go to work. I said, you cannot deduct your gas. And he said, well, why do you think I drive downtown; to go to my job.

It turns out at the end of the evening, as I was watching this, he deducted almost everything he spent. That was his—and I do not think that he was ever audited in his life—but most people, of course, would be intimated to do that. But——

Mr. GOLDBERG. Have you got his name, Congressman? [Laughter.]

Mr. DORGAN. He actually probably does not meet the threshold here any longer.

Mr. SCHULZE. You could probably investigate all of his classmates.

Mr. DORGAN. That is right, but the point is that most people do not do that. But there are some people who just decide at tax time, until they catch me I am going to take advantage of everything. And, you know, 98 percent of the people are not like that. And those 98 percent who do honestly pay should expect the Internal Revenue Service to be able to go to those others, some of whom have millions of dollars, and say to them, you have an obligation also to pay your fair share, and if you do not, we are going to fine you.

Mr. SCHULZE. I am glad I do not know anybody like that. [Laughter.]

Mr. POSNER. Mr. Dorgan, if I could just add to one thing that the Commissioner said. It is not just a matter of resources in some of these areas. There are some efficiencies and improvements in the various programs that we think could be made. We issued a report 2 weeks ago, as the Commissioner alluded to, on training. To train its new revenue agents, IRS pulls some of its most experienced people off the line, and we estimated that in five districts they are losing about $1 billion.

And we think that if they went to a different approach where they contracted out the training and did other kinds of innovations, you could really maximize more of those resources being on line.

The same thing goes for the high appeals rates and the low sustention rates. One thing that might be causing the decline in exam coverage—of course we do not really know completely—might be the growing number of cases that are appealed and the need for examiners to spend time preparing for that.

And that is why this study that IRS is doing is so important—to find out why cases are appealed? What are the reasons? What can be done about it? What kind of improvements can be made maybe in quality?

So it is not just resources. I just wanted to emphasize that.

Mr. GOLDBERG. I do not want to beat this same drum again, and again, but the fiscal year 1991 budget includes specific dollars to hire contractors to present IRS training, so that we do not have to do what we did before. And, again, this is an area that we have been working on with GAO. We changed our programs last October, November, and December to deal with that point. So again, what do we want to do with some of that money in the 1991 budget that we are asking for? It is to hire outside folks to do training, to avoid losing money because our employees are teaching and not working cases.

And again, it is running the business better. We are making the request.

I cannot resist going back to your question about decline in audit coverage. We have mentioned two reasons. One is shelters, and I think that the growth in returns is another. There is a third reason, and it is the one that you alluded to. Tax returns today are much more complicated then they were in the past. And the plain fact is that it takes more time to do an examination today, because it is just a lot harder. So I think that is a third factor we cannot lose sight of, and it is another reason why we should be pursuing the simplification you allude to.

Mr. DORGAN. And the capital gains will not further simplify the Tax Code?

Mr. GOLDBERG. Unfortunately, Mr. Dorgan, everybody is already living with all of the capital gains rules. There is no additional complication there whatsoever.

Chairman PICKLE. And now, Mr. Commissioner, the Chair is going to yield additional time to other members as we go around again.

We must admit that we have got to do a better job in the area of tax compliance. It may be better than some nations or most nations, but it is not fair to the average American taxpayer if he knows that he is paying his taxes and about 20 to 25 percent of the other people are not.

People are not going to accept that. The people who really suffer are the employees. People who are employees, they cannot duck it. Their money is raked off. They cannot write it off. They may try and they may want to, but it is just not much way for them to do it. They pay their taxes. But a lot of the employers, independent operators, corporations—small and large—find a way to write off, have losses.

We are guilty of that to some extent, but the person we are hurting really is that individual who takes his money, is raked off by the employer. Now, I do not think that we ought to try to explain away what a good job we are doing because we understand this complex problem.

We have got to do better. We have got to increase your audit, you accept that. You have got to have more enforcement. And I think, regrettably, we probably have to have more criminal prosecution. I think you will find, if you look at criminal prosecutions, nearly all of them are leveled against individuals, not against corporations, individuals. And I dare say, if you looked at the figures, Commissioner, they would probably be 80 to 90 percent of them against individuals, not against corporations.

And yet, Mr. Commissioner, corporations ought not to have any underreporting or overreporting. They have got people hired who know what the law is. There is no excuse for them to be filing a false return. They are qualified people who purposefully submit those figures in most cases.

Would you disagree with that? You just have to almost admit that.

Now——

Mr. GOLDBERG. Mr. Chairman, I think that clearly happens from time to time, but I am telling you, the law out there is a mess for corporate taxpayers, and just too darned complicated.

There are cases where folks out there are flat out crooks and cheats in the corporate sector, and they should go to jail. I agree with you, but I think by and large, the compliance problems in the large corporate sector——

Chairman PICKLE. I think the public probably feels, that for the most part, the Internal Revenue Service does not go after the large corporations. You go after either the small corporation or the individual.

Mr. GOLDBERG. We audit 100 percent of the largest companies in this country, Mr. Chairman.

Chairman PICKLE. I will have to look at some figures. I just got a figure that it is difficult for you because in many respects, they got more people in their tax division than you have in your tax division.

Mr. GOLDBERG. That is for sure.

Chairman PICKLE. And a lot of them have come from your organization to begin with, because they have been hired all away from you and they know how to beat the system and it is hard for you to combat it.

Just a comment, in some respects, it is an unfair fight.

Mr. GOLDBERG. Yes, sir.

Chairman PICKLE. And I do not think that we ought to admit that and we ought not to say that neither side, that they are just guilty of criminal intent. But that is the cold fact of the matter.

Now, when that is going on and you are not auditing or getting from the big corporation money, the little fellow is going to feel like, well, I have got to get mine too. So he is going to try to cut a corner wherever he can.

Now, we have got to change that attitude and we need specific recommendations from you. Let me come down to an example.

What are you going to recommend in the area of independent contractors? What do you recommend on that?

You point out that it is a problem. It is a problem for the Congress too, but now from a tax standpoint, what do you recommend?

Mr. GOLDBERG. Well, Mr. Chairman, we are approaching it from several directions. One—and again, I think the General Accounting Office is right on the mark—we are preparing a compliance study that will help us better understand what is going on there, so that we can target the remedies the right way. In terms of what we specifically ought to be doing, we have underway, under existing law, an enforcement program targeted at that issue, the misclassification of workers. Beyond that, in terms of a longer term legislative solution, we are working with the Treasury Department, the administration, our colleagues in State and local tax administration, and various taxpayer groups to see if there is not some way to deal with this problem that is fair to small business as well as fair to the individuals involved.

We do not have a specific legislative proposal at this point.

Chairman **PICKLE**. Well, here is a corporation or a business and they have their employees. The business pays their employee tax and that goes into unemployment compensation, Social Security and all of the other aspects of it. But that tax money is paid.

Now, here is another corporation that is not audited and they have a lot of independent contractors. Is that unfair competition?

Mr. **GOLDBERG**. Yes, sir.

Chairman **PICKLE**. Now, is there a way that we can formulate or put together a formula or a test that would be fair? Will your study target that kind of a question?

Mr. **GOLDBERG**. Yes, sir.

Chairman **PICKLE**. Now, you are going to have that study underway for 2 years. You said you would be able to have it here in the next few months.

Mr. **GOLDBERG**. No, that study is going to be done this summer, I promise you.

Chairman **PICKLE**. I want you to promise me again, when are you going to have that study out?

Mr. **GOLDBERG**. This summer.

Chairman **PICKLE**. Well, at least we will say the summer of 1990.

Mr. **GOLDBERG**. 1990, you got it.

Chairman **PICKLE**. Well, and I do not know that your study is going to say how you specifically will settle the question of employee versus the independent contractor. We do know that we lose a great deal of income because of this issue, is that correct?

Mr. **GOLDBERG**. We lose billions of dollars, yes, sir.

Chairman **PICKLE**. How much would you say?

Mr. **GOLDBERG**. We do not have the precise numbers, yet, but our understanding is that——

Chairman **PICKLE**. How much?

Mr. **GOLDBERG**. It is in the billions of dollars.

Chairman **PICKLE**. Would you estimate how much we lose over the independent contractor issue?

Mr. **POSNER**. I believe we have a figure of $1.6 billion for 1984, and I believe it comes from IRS' data, yes.

Chairman **PICKLE**. That is $1.6 billion.

Mr. **POSNER**. Yes; for 1984.

Chairman **PICKLE**. OK. Well, in citing those figures, I do not think that we ought to say immediately we are going to classify everybody as employee rather than independent contractor, because there are many instances where that is a proper and appropriate decision to make.

But, at the same time, it is a revenue loss as far as noncompliance is concerned.

Well, now let me look at some of these individual cases. Commissioner, you said that in the area of the sole proprietors, we are losing about $16.6 billion. That is your figure. You do not give me a breakdown on it, but at least those are your figures.

And your report is going to show me that breakdown soon, when I get that report. But at least we have some breakdown now from the GAO. Let me look at some of these figures. In the area of the sole proprietor, the GAO found that sole proprietor in service industries, like doctors and lawyers, had underreported the most tax dollars.

And the sole proprietors with fixed locations sales, like car dealerships, restaurants and clothing stores, underreported the greatest percentage of their tax. Now, let us look first at the doctors and lawyers. They had the most underreported tax dollars of all. And how do lawyers and doctors underreport their income?

Mr. **Brennan**. We do not keep records like that, sir.

Chairman **Pickle**. You say you—now, how do they?

You say you do not have records, but have you ever looked and tried to find the answer for that?

Mr. **Brennan**. What we have done, in terms of this area, is to target what we call compliance projects into areas where there is unreported income. And so, we do have projects going not only in our districts, but nationwide, to focus in on areas where there is a heavy concentration of cash businesses or cash transactions.

And we find——

Chairman **Pickle**. GAO, could you answer that question?

Mr. **Posner**. We did not get the data sufficiently detailed from IRS on that point to be able to really understand what it was about their noncompliance, and what it was about them that caused them to be noncompliant.

Chairman **Pickle**. Well, I just raised the question myself. Not that I want to impute criminal intent to anybody, but here you have got one group, the doctors and the lawyers. And it is showed clearly that they had the most unreported tax dollars. And you go into the other group, the same way. The restaurants, the clothing stores, and the car dealerships, they have a high percentage of noncompliance.

Now, that is fact, so that it looks to me like there are some serious question about our reporting system; our examination system. And we have to look at those groups as a whole. One of the biggest groups of noncompliant reporting, I understand, are accountants. [Laughter.]

Chairman **Pickle**. Now, if that is so and if you have been——

Mr. **Goldberg**. Mr. Chairman, I may wait around for the next panel. [Laughter.]

Chairman **Pickle**. Well, if that is so, it seems to me like the accountants have learned how to beat the system, and they take the risk. I surely do not want to indict them as a group, but as a group, the figures show that they are guilty of this as much as any other one group. Now, is that not alarming?

Mr. **Goldberg**. Yes, sir, and again, I would like to refer back to the GAO report. I think that one of the things that we need to do better, as an agency, is to understand and focus on more targeted areas of noncompliance.

If, in the professional services industry, that is a problem, then maybe it should not be just part of an overall effort. Maybe we should do more to understand what is going on there, and what kinds of enforcement techniques are most effective. And I think we need to move away from these global tax gap figures and deal with more precise issues, exactly in the manner which the GAO has recommended.

Chairman PICKLE. Mr. Schulze, do you have additional questions?

Mr. SCHULZE. Yes, Mr. Chairman.

I was going to ask about those figures. It seems to me, that it may be that my personal preference is showing, but I believe it might be true about lawyers, but I do not think that the accountants would be. It seems to me if there is a group who is more aware of what is going on, it should be the accountants. It is to their benefit to comply up and down the line. It is just not worth it to the average accountant to play games with his own tax return.

I would have to have a little more proof on those figures to believe that tax practitioners would really play that Russian roulette and try to game the system.

Thank you, Mr. Chairman.

Chairman PICKLE. Well, now, Commissioner, let me ask you a question about why these taxpayers are not compliant. In 1988, the IRS coordinated examination program, the CEP, contained only 276 corporations that were ranked among the top 500 corporations in assets value. Most of the other 224 corporations not included in CEP came from banking and finance industries, in those two categories.

Now, in 1988, the IRS completed examinations in 307 of the 1,461 CEP corporations. Two-thirds of the top 307 corporations accounted for $6.5 billion of the $8.9 billion in recommended taxes; 21 petroleum and banking cases accounted for $2.5 billion.

Exactly why were large corporations in the petroleum and banking industries responsible for the highest noncompliance? Can you comment on that?

Mr. POSNER. I would just direct your attention to the back of our report. One thing that IRS does is to keep a digest of the key issues of noncompliance and controversy in industries; back on page 108 of our report in appendix 8, we have listed those issues for you that IRS has reported through its ISP Industry Specialization Program for commercial banking.

And then again, on page——

Chairman PICKLE. I am trying to ask you, the GAO, or the IRS, why are so many banking industries responsible for this highest noncompliance and why are so many of these industries not being audited? Why are so many banking businesses excluded from the CEP program?

Commissioner, why are they?

Mr. BRENNAN. The banking industries are not excluded from the program. What we do in terms of CEP and who goes into it, involves a seven-part criteria: gross assets, gross receipts, number of operating entities, number of industries, number of team members to do the audit, how many support audits and how many days we will use on it.

That——

Chairman PICKLE. Well, Mr. Brennan, the GAO report on page 98 shows that the recommended tax—in this last column—the recommended tax in 1980—this is after the audit now—shows in the aerospace industry that the recommended tax would be $300 million; in automobile, $310 million; in banking $1.13 billion; three or four times as large. On down further in the column, it shows in the petroleum industry, the recommended tax under the CEP is $1.34 billion.

Now the banking and petroleum industries, out of the $8 billion, those two alone represent almost 30 percent of the entire figure. Why is that? Why are you so lax in the two fields of the banking and petroleum industries?

I want to know specifically how are the banks noncompliant?

Mr. **Goldberg**. Mr. Chairman, I would like to make a couple of comments about this table.

Chairman **Pickle**. All right.

Mr. **Goldberg**. First of all, all of these taxpayers are under examination. The second column is only those examinations that were closed. In other words, there may be another taxpayer whose examination was not closed, so that it will be in the first column and not the second.

We are examining all of those taxpayers.

Second, as I said in my testimony, and as GAO said, it is very important that we understand that recommended taxes do not represent taxes owed. We can recommend that a taxpayer owes $20 million, but if the Tax Court says that taxpayer does not owe a nickel, that taxpayer does not owe a nickel.

And the fact is that our recovery rates or sustention rates, how well we do when the cases go all the way through the system, are not necessarily reflected there. What we are doing— and this is a very good program by identifying, for example, the banking industry—if there is a compliance problem in the banking industry, if there is a set of issues unique to the banking industry that raise countrywide compliance problems, we are identifying them. We should be sharing these issues with the Congress.

For some of these issues, it may be that the law lets the banks do what they are doing, and maybe the law should be changed. But I think that I would not use these numbers to conclude that the banking industry is a bunch of crooks and cheats.

Chairman **Pickle**. Well, I hear you but I repeat again to you that 21 petroleum and banking cases accounted for at least $2.5 billion of these figures. Now, that is a fact. That is about a third of the entire figure.

And it just seems to me like you are not paying attention to them. Let me propose a theoretical case. What would have happened if we had had an IRS presence in the banking industry in connection with the savings and loan debacle?

Could you have detected that? Would you have been able to issue a warning to the Nation about it? If you have no presence there, and if they are not paying their taxes, then you do not really know what is going on in those kinds of institutions.

Mr. **Brennan**. I think that we do have friends there, and maybe Paul can explain the figures a little bit.

Mr. **Posner**. Well, I would just say that these are areas where IRS has been auditing the corporations, Mr. Chairman; so IRS has been active in these areas. However, I would add that many of the large corporations that they do not audit are also in the banking and financial services area. So that it is somewhat of a mixed bag here.

Mr. **Brennan**. And what the column represents, if I understand it correctly, is that they are just talking about cases that were closed in 1988.

Mr. **Posner**. That is correct.

Mr. **Brennan**. It does not show on here all the cases that would be open that we would be examining.

Mr. **Posner**. That is true. This is cases closed in 1 fiscal year, fiscal year 1988.

Mr. **Brennan**. So you cannot tell. I would suggest that you would not draw a conclusion from this sheet that we are not in petroleum or banking, et cetera. We are, particularly, on the very large ones.

Chairman **Pickle**. It would be interesting to the committee to know how many actual audits you have made, you have made actually in the petroleum and the banking industry and we would like to get those figures from you.

Mr. **Goldberg**. We will submit them.

Chairman **Pickle**. I do not want to point a finger at those two, but when I look at the amount of recommended tax in the 1988 year, and those two categories constitute at least a third, it seems to me like the banking and the petroleum industry are not paying their full taxes.

Mr. **Murphy**. Mr. Chairman, you can also get——

Chairman **Pickle**. Mr. Murphy.

Mr. **Murphy** [continuing]. Those numbers and say it appears as though there are issues of tremendous substance that are being raised by Internal Revenue on those as well. And as you know, there are issues in the banking industry and the petroleum industry that should cause Internal Revenue to propose adjustments.

And, as the Commissioner said, all this may lead to legislation that we should be talking to you about as well.

Chairman **Pickle**. I don't suppose you could give me a figure, but have you audited many banks in this country?

Mr. **Murphy**. We can provide all the specifics on that to you, Mr. Chairman.

Chairman **Pickle**. I know you can. I asked you to do that. But I am asking you at this point, though, have you got any suits pending against banks in this country, very many of them?

Mr. **Brennan**. Suits, I couldn't say. But I would say that with the major banks, the large banks, there are a substantial number of them under exam at any one time. The same would apply to the petroleum industry.

[Additional information follows:]

IRS Activities Related to Banks

Nationwide, there are currently 677 commercial banks and 366 savings and loan institutions under examination. There are 23 banks and 7 savings and loans (each with $10 million or more in dispute) in nondocketed status, and 17 banks in docketed status in either the Tax Court or District Court.

Chairman **Pickle**. Well, I have the feeling that if we had been auditing many of these banks we would have found that the banking program has not been sufficiently audited or regulated by our banking system. And the Internal Revenue Service, had we had presence in those banks, would have detected that earlier than we did and could have made a great contribution to the Nation. At least, you could have alerted the Congress more, and we could have done something about it. But we all did a poor job on that.

I wonder sometimes are we just not auditing and not bringing suits against banks or big industries like petroleum just because we just don't want to compete with them and it is just too difficult. Or we don't look at some of these large lawyers. I am told that in New York State they have discovered that a number of partners in the larger law firms were not fully reporting their income.

Now, Commissioner, have you been cooperating with New York State in this investigation?

Mr. **Brennan**. I do not know about this specific investigation.

Mr. **Goldberg**. We work closely with the States in enforcement.

Chairman **Pickle**. Say that again?

Mr. **Goldberg**. We do work very closely with the States in various enforcement efforts. From what I have at least read about those stories, they are reporting their total income. The question is what portion they are reporting for New York and what portion they are reporting for Connecticut.

Chairman **Pickle**. Well, the Chair has got some other questions I want to come back to, but let me yield at this point to Mr. Dorgan. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

I might observe that when I was a tax commissioner for a State that the IRS did, indeed, cooperate closely. But I also am concerned that the cooperation that existed when they had much greater capability back in the 1970's even then was the kind of cooperation that was kind of cumbersome and slow because, it's a muscle-bound system. Particularly in tax investigations that might result in a prosecution, you are dealing with justice and the whole range of things, and your procedures are much more difficult and lengthy procedures than some of the State procedures. So I wonder whether the capability of working with those States has diminished as well because of the diminished resources.

I would like to continue down this road with respect to the question of corporate auditing, because my understanding of table V-14 is that recommended tax and penalties, 11.6——

Mr. **Murphy**. Mr. Dorgan, are you referring to our testimony?

Mr. **Dorgan**. I am on page 99 of the GAO report. My understanding of that page is that that represents the examination results of large corporations, and that is used as part of the tax gap, the examination results, part of the tax gap. That doesn't tell me what you would estimate the tax gap to be if you projected the actual examination results. My question to you and the GAO is: We are making projections in other areas. What about large corporations? If this is actual examination results—and I assume that the result of these examinations is not a frivolous result. You don't just go in and grab a number and say, well, we will hold you for $500 million until we find a better number. That is not the way you do auditing or not the way you examine taxpayers. If this is not frivolous and this is actual examination results—admitted that some of it will perhaps be diminished as the process moves on—but what would you then expect the tax gap to be if you project the results of actual examinations to the entire universe of corporations?

Mr. **Brennan.** I think it is in the tax gap, and John can comment on that. I would point out that, as the Commissioner has testified earlier, in the over $250 million category, that does represent what examination has asserted. Taxpayers increasingly take their cases to appeals or to Tax Court, and more and more of them are being sustained.

Mr. **Dorgan.** I understand that. But the point is, if these are actual examinations and if it is what the IRS has asserted—and some of that is contestable—if you would project this to the entire corporate universe, what kind of noncompliance or tax gap numbers would you get from the corporate sector—large corporations over $250 million?

Mr. **Johnson.** This does in fact represent, sir, the extension of the experience towards the total universe. We are not satisfied that our past methodology of estimating the gap for corporations is correct, and we are in the process now within the research division of developing what is the equivalent of a TCMP program for large corporations. It will be based on the experience of those initial reviews, which will, of course, take a year or two to conduct. We will then be able to answer your question with considerable precision.

Mr. **Dorgan.** But I still don't understand your answer. My understanding from the labeling on this page, this is not an extension of anything except it is a listing of the examination results for over $250 million in corporations—that is, corporate size, the largest of the large corporations. You have $9.3 billion. That represents examination results. Now, how has that been extended to represent what the results would be if you take the entire universe of large corporations?

Mr. **Goldberg.** Mr. Dorgan, my understanding is that, in fact, we use those recommended adjustments as the basis for projecting noncompliance for all large corporations. So, in fact, tax gap numbers do include a projection based on those results to cover a hundred percent of the large corporations.

Mr. **Dorgan.** But where is the projection, then? The $9.3 billion is examination results, not the projection.

Mr. **Posner.** Mr. Dorgan, for our study, we didn't project. We took cases closed in fiscal year 1988, and this is a different type of analysis than what they did for their tax gap figures. They used I think exams completed through 1986, I believe, and they did do some projections to, I believe it was, some of the smaller corporations.

Mr. **Goldberg.** Mr. Dorgan, if you look at the chart in my testimony—and I think it is on page 3—we show the breakdown by large corporations, and we show a number in there for large corporations. It is on page 3, Mr. Dorgan. We show large corporations as accounting for $16.8 billion. Now, that is a projection out to the universe of large corporations. For purposes of this hearing, we defined large corporations, as you requested, to be $10 million and more in assets. We could break that number down and provide you with the portion of those dollars attributable to corporations over $250 million, if you would like that information. It does include the universe of those companies.

Mr. **Dorgan.** That explains the GAO table versus your testimony.

Mr. GOLDBERG. Right.

Mr. DORGAN. I appreciate that.

Mr. MURPHY. Mr. Dorgan, keep in mind on those recommended tax figures you have that you have got multiple years in there, too; whereas, we are talking 1 year for tax gap purposes.

Mr. DORGAN. Yes, I understand.

Let me go further, then, if I might. As I said before, when you do an audit on a corporation—first of all, corporations are growing. In the last 20 years, there has been this fever of mergers, and we have had larger corporations getting larger, and they hire the best tax advisers to prepare their tax returns. We had an experience here not too long ago which is very typical of virtually everything we now do here on the tax-writing committee. We imposed an excise tax on greenmail, which I sponsored, and the first reaction of Wall Street and the lawyers was, well, now, not how do we comply with this, but how do we find a way around it? That is the first reaction. And that is the reaction, it seems to me, often in many of these large institutions. It is how do we minimize our tax obligation, is there some way to sneak around the corner here. And I think that is often the mentality. That's why you find $9.3 billion in your examination results. That is why your people pick it up.

Now, if corporations are getting larger, if the job is getting more difficult, if the mentality is let's find a way around this rather than let's comply with it, doesn't that mean that we have to devote even more resources to this area? And if so, what kind of plans do you have down at the Service to devote more resources, particularly and especially in the large corporate area, so that we have some basic notion that this $16 billion that you project out there is $16 billion that will get to the Treasury?

Mr. GOLDBERG. Well, Mr. Dorgan, as I indicated in my testimony, we already devote 25 percent of our examination resources to large corporations, so we were doing an awful lot in that area. It is my personal judgment that in the large corporate taxpayer area the issue is not more resources. I mean, that is part of it, but I think the primary issue is the quality of the work we do and the approach we take to these examinations. If we examine a company whose headquarters is in Chicago, we do our examination in Chicago; but that company has subsidiaries all over the world, and we may not be doing the quality of the job we ought to in examining that taxpayer. So I don't want to minimize the need for resources, but I think in the large case area, to the extent we do need more resources, I think we need them for expert witnesses and outside appraisals. I think that it really is a quality question, and I would like to share with you the report that we have developed in this area.

Mr. DORGAN. You indicated that 25 percent of your audit resources are devoted to those large corporations. I indicated earlier that the audit coverage of large corporations has decreased by 40 to 50 percent. When it was 40 or 50 percent higher—that is, the audit coverage of those corporations—what percent of your audit resources were devoted to auditing large corporations?

Mr. GOLDBERG. The committee defined large corporations as $10 million or more. When we talk about large corporations internally, we are talking about our Coordinated Examination Program, the

1,600 biggest companies around. Our audit coverage of those 1,600 companies is 100 percent.

Mr. BRENNAN. $250 million and over is our definition of CEP, or large case. We use the terms interchangeably sometimes, but CEP is the official title. Any corporation with $250 million and over is reviewed, and all of them that we feel warrant an audit are examined every year. We don't feel they all warrant it, so it works out in the neighborhood of 60 to 65 percent in the last 2 years, and I don't go back any farther than that. But I would be surprised if it changed much. That is the coverage percent for corporations of $250 million and over.

Mr. DORGAN. Mr. Goldberg, I read a press report—and I don't necessarily view that as authoritative, but it may be reasonably close to the facts—that 60 percent of the largest 100 defense contractors are under investigation for fraud, or have been under investigation for fraud during this decade. What does that tell you as a tax administrator with respect to the behavior and the operations of large corporations in the tax area? Does that lead you to wonder whether there are significant tax compliance problems and whether your normal assessment—you know, when you get to be a $10 billion corporation, you have to start from the assumption they are going to basically pay up. We start with that assumption for the folks who are on W-2 forms. What the heck, they don't have a lot of flexibility. You get a wage, you get the tax withheld, and that is sent to the IRS. You have no flexibility. But an entity that is $1, $2, $4 billion, there is incredible flexibility on what kind of taxes they pay.

When I started the original joint audit program so that many States could come and audit one corporation together, very controversial when we started that back in the 1970's. But we started with the notion that there is probably a great deal of nowhere income out there, and we discovered that there was a great deal of nowhere income because in almost every case a group of people in that entity were trying to figure out how could they minimize the tax obligation for the corporation. So you have got to come and find it. That was the attitude. If you want it, you come and find it.

Is that same aggressiveness exhibited now at the IRS with respect to the largest enterprises, that we had better go find out what is there because in many cases they are not likely to volunteer it?

Mr. GOLDBERG. Mr. Dorgan, I believe it is. And I think that the "nowhere income" point that you make is a good one. Our analogy to that situation vis-a-vis the 50 States is in the multinational corporate context, where it is not just "nowhere" for us, it may be nowhere for England, Germany, and everybody else. So I think that we have similar issues. Obviously working with our treaty partners is a lot more difficult than the 50 States working together.

But I say that is an area that is very important. As I say, it is receiving a great deal of attention. This committee is going to hear about a certain piece of it in the international context at a subsequent hearing.

We are working those questions very hard, but I think that we need to be realistic about it not being just more bodies—it is doing our job better. With the complexity of the tax law, the myriad provisions that folks can work with, the regulations they can work with, I personally do not believe it is a question of out-and-out cheating; they do not need to and there is no reason to.

They are public companies and they will get slaughtered if they do that. So I do not think that is happening. I think what is happening is that there are technical issues affecting large corporations, where quite properly their tax advisers say you could try this and you can try that, and this is what the law seems to say. And if the law is unclear and it is full of complications and the right answer is none of us know, then it is 50-50 either way. My personal judgment is that the corporate taxpayer quite properly calls it its way. That is the way our system works. Our job is to find that 50-50 call and challenge them.

Mr. DORGAN. And the only way we can do that is if we have an understanding that it is our job to be aggressive and assertive in developing a program that accomplishes that. And that is the purpose of all of these questions from the subcommittee. Do we have that kind of assertiveness and that kind of organized program to find that money?

Mr. GOLDBERG. Do we have the training of our employees so that they can find those issues? Do we have the resources to hire the expert witnesses to deal with the evaluation questions and issues like that? Do we spend our resources dealing with rollover items as opposed to the kinds of issues you are talking about?

I am very troubled by all of those questions. I think as an agency we are concerned about exactly these issues. And I think they are way up there on the list of things we need to be doing for all the reasons that you say.

Again, what we are looking at I would be happy to share with you and GAO and others. For some of the directions we will be pursuing, we also need the money to get the job done.

Mr. DORGAN. Just one final comment. I am also troubled, I think by some remarks that were expressed by the chairman with respect to what we see in banking and petroleum. The implication from these numbers is that we have got substantial tax compliance problems in both of those areas and I wonder whether the Internal Revenue Service—I do not want to duplicate a question that the chairman may have asked—but wondered whether we have, when you see areas—for example, there is a substantial difference it appears to me in results from electronics versus banking, or electronics versus petroleum. When you see that, as an administrator, do you decide well, like Willie Sutton did, we had better go where the money is here and figure out how to deal with it?

So we are moving our resources into task forces to deal in these areas—petroleum/banking, versus another area?

Mr. GOLDBERG. Well, I might say, Mr. Dorgan, that maybe those high numbers suggest that that is what we have already done. In other words, those numbers are high because we have focused enforcement efforts in the banking area and in the petroleum area. And so I think it may be a product of what you are describing, as opposed to an indicator that we should do it.

Mr. BRENNAN. It also could be that 1 year. It takes us longer than I am sure we all would like to examine some of these large corporations. And so I would say that looking at 1 year's figures is insufficient. I would want to see 3 or 4 years, I think, before I drew a conclusion, because you may look at the next year and find almost the reverse of what you are looking at here. All I am saying is that I do not think that you have got a pattern for 1 year that shows that we are not into whatever industries look low.

Mr. POSNER. I think that is appropriate, Mr. Dorgan. I also think it reinforces the need for IRS to do tracking by these industries and by issues, so that they can actually tell us what are the issues at stake? How many dollars, by issue in each industry are at stake. How much is being lost through the appeals process? Why? What legislative changes are needed?

IRS does not have that issue tracking system in place as needed. I think if they did we would be able to have a better diagnosis of the problem.

Mr. GOLDBERG. Mr. Dorgan, I think it is a common theme not only in this hearing but other hearings. And I think Paul is right on the mark. One of the frustrating things all of us deal with is we do not know right now, on a case-by-case, taxpayer-by-taxpayer basis what happens all the way through the process. In other words, we may say the petroleum or the banking industry owes $1.3 billion. Well, if the Tax Court says they owe zero, they owe zero.

And yet, we need to do a better job of managing the system as a whole. One of the things that we will be implementing this summer, which I think is of enormous significance, is the ability to track these cases, and track these issues through from the time they start until the time the gavel falls. And I think that is very important.

I think another piece of it is that these folks are very well advised, and it may well be that results that do not make sense to us are permitted by the law. And one of the things that we need to do a better job of is calling this to your attention, Mr. Dorgan: this is the result; you can change the law and get that money. And I think we need to do a better job of calling your attention to those kinds of questions.

Mr. DORGAN. Well, and again, let me emphasize that my concern has been over the last decade or two that there is a kind of a growth in the perception of people out in the country that it does not matter to us what the IRS wants to contest, we will do it our way and let them come and find us. I am talking now about some awfully big taxpayers.

This is what those folks say, not how do we comply, but how do we get around it. That is our attitude. And I just think that when you say we have got $9 billion from large corporations—over $250 million that comes from audit results, and you extend that, I believe you said to $16 billion or something in that neighborhood—and if we are only covering roughly 25 percent I believe audit coverage of the very large corporations—I mean $16 billion could be very well low-balling the estimate of what we should be getting if we had much, much broader coverage.

And I hope maybe the study that we get from you this summer would give us some amplification on those numbers. And I do not want to keep dwelling on it, but I—especially because of the politics of this issue—the notion that somebody running for office says well, what these people want to do is to put an auditor in your kitchen and chase old folks in tennis shoes to try to get an extra $5 in taxes.

That is not the issue. The issue is if you have got a $5 billion corporation that ought to be paying an extra $500 million in taxes, but has got some sharpies who have decided you are not going to get it unless you come and find it, and even when you come and find it they are going to fight you on it. I would like to make sure that those folks pay their taxes, because the folks that work all day for a living and work hard do not have any flexibility—they pay their taxes and do it honestly. That is the purpose of this American system.

Mr. GOLDBERG. We have got to make it easier on the little guy and we have got to spend more time chasing the big guy. And I agree with what you are describing. Not necessarily with respect to large companies, but when somebody out there, a sole proprietor making $400,000 or $500,000 knows that the audit coverage is down below 2 percent, we have got a problem. And I agree with you, we need to build that audit coverage back up.

Mr. DORGAN. Thank you, Mr. Chairman.

Chairman PICKLE. Well, at the beginning of the hearing, Mr. Dorgan pointed out that we have a considerable problem in the tax gap area. And the question is, what can we do about it?

Mr. Commissioner you admit, by and large, that we need to find better ways to collect the money. And while we can be proud that we collect over $1-point-plus trillion in taxes, at the same time, we do know that 20 to 25 percent of the people do not fully comply with our tax laws. That is wrong.

Now, we cannot turn our Internal Revenue Service into a Gestapo. The American people would not tolerate that. But somehow we have got to seek a better way to increase our compliance rate.

Now, I am going to suggest that one way we can do it, in addition to whatever legislative steps we could take at this point, is that we create a tax compliance roundtable committee and have various elements of our society represented on the committee to see what they, together, would recommend as a proper approach. I suggest that we have a committee similar to the committee that we created when we approached the civil tax penalty problem. Together, that group composed of Internal Revenue Service Commissioners, the Treasury, and the IRS, the bankers, the lawyers, the accountants, the little folks, came up with a proposal that seemed fair with them as a group. And our subcommittee took it and recommended it and now it is the law.

And I think probably the recommendations from this approach has made the tax system, from the penalty standpoint more fair than ever before. I suggest we create the same type of a roundtable tax compliance committee, to have them meet to see if they could make a recommendation to us. And we, and our subcommittee will be meeting with them. At least I am going to recommend that. I think that would be good.

Now, we have got a panel coming up in a few minutes that I want to ask some questions or get their comments about. I want to see what recommendations they would have.

And I know that this has been a lengthy hearing, but let me ask you a couple of more questions.

Mr. Commissioner, you have indicated that—maybe I misunderstood—that your so-called coordinated examination program, the CEP program, was going well. Did I understand you to say that it is going well or not going well?

Mr. GOLDBERG. Mr. Chairman, is the glass half-full or half-empty? I think that we are doing good work, but we are very concerned about some of the results in that program. For that reason, we are thinking about making major changes in that program to do a better job. So are we doing a good job? Yes, in some areas we are. In the petroleum industry, I think we are doing a really good job. In other areas, we clearly are not doing a good job and that is why we are thinking about changing the program.

Chairman PICKLE. Well, our staff, in talking to some of your folks, have indicated that they got the report back that, in general, the CEP program was just in chaos. That it was not very effective. And now maybe that is just a small group, but apparently there are serious questions about how it is operating.

And I would think that if we could revise that program or get a better program it would be better for us. And I think that if we had had a good examination program we could be doing a better job.

Now, I am told that 70 percent of the adjustments that had been recommended by Examination have been conceded by the Internal Revenue Service once the cases reach Appeals.

Now, either the auditors were not making a valid assessment or else Appeals, IRS appeals representative was bargaining away their cases. Which is it? If 70 percent of the cases are conceded, is that an acceptable figure? Is that reasonable?

Mr. GOLDBERG. Mr. Chairman, it is all of the above. I think it is some situations where we raise improper issues. It is other situations where we should not settle for what we are settling at. That is why we are studying that area. We have been looking at that area now for a number of months. And as I have said, we have a report that recommends changing the way that we run the CEP program to deal with exactly the concerns that you are raising. And I agree with you.

Chairman PICKLE. Well, if we had been having very thorough CEP examinations, say in the banking industry, I said earlier that I think that perhaps we might have, the Internal Revenue Service ought to have been able to detect some of the discrepancies going on in the savings and loan industry.

And I am convinced that that is right, because either the large corporations and banks, they were either violating the law or the Internal Revenue Service were making unreasonable and making wrong tax assessments. It has to be one or the other almost and I think that this is something that we really needed to look and we looked at very carefully.

Now, I know you are looking at corporations, but, Commissioner, we, our committee, we gave you, the Internal Revenue Service, a list of the Fortune 100 Companies and we asked how many of these have been audited? Now, that was 2 or 3 months ago we asked you that so that we could get ready for this hearing. And every week we have asked you for the same information.

We have not gotten that information. Can you tell us why?

Mr. GOLDBERG. Mr. Chairman, I am going to look at the information before we send it to you because I want to be sure it is right.

Chairman PICKLE. Your answer is too soft, Mr. Goldberg, what is it?

Mr. GOLDBERG. Mr. Chairman, again, we are putting it together and we will make certain that we get it to you in the very near future.

Chairman PICKLE. Yes.

Mr. GOLDBERG. I cannot tell you why but we will get it to you shortly.

Chairman PICKLE. Yes, the 100 of the Fortune 500.

Mr. MURPHY. Mr. Chairman, we got the request 2 or 3 weeks ago. And it required extensive work by our field offices. We have not received it all yet. We will get it to you.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

JUN 19 1990

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

This is in reply to your letter received on March 26, 1990, in which you requested information on the top 100 largest corporations and the 100 wealthiest individuals.

As discussed with Mr. Pat Heck on your Subcommittee's staff, we were unable to immediately provide detailed information on the issues raised in examinations since the taxpayers' files had to be retrieved from storage in many instances. In the interim, we want to provide the following information.

All of the top 100 largest corporations have been examined since 1985 or they are currently being examined. The audits generally include tax years 1986 and prior years. With respect to the 100 wealthiest individuals, we want to advise that 81 of these individuals have had one or more returns examined since 1985. As of this date, 19 individuals have not had their returns examined for any year from 1985 through 1988. We note that 1988 returns are still routinely being ordered by the district offices based upon their workload needs, and the 19 individuals could still have their 1988 returns selected for examination.

For tax year 1985, the effective tax rate based on taxable income reported was at or within 3 percent of the top marginal rate for 69 out of the 100 wealthiest individual taxpayers in our sample. In 1986, this figure was 76; in 1987, it was 52; and in 1988, it was 85. This, however, is not necessarily an indication that these taxpayers paid the proper amount. For this reason, we process all returns through our Discriminant Function System (DIF), which is a computerized system that uses a mathematical formula to generate a "score" for each return that is commensurate with the potential for error. Based on the DIF score and other information, returns may be assigned for examination.

All returns in our sample that have been identified for audit to date were manually screened by experienced examiners to identify items on the returns most likely to contain errors (our classification process), and the returns were then made available to field examining groups for examination. Often, examiners expand the examination to include other issues as the audit progresses.

During the classification process, classifiers may decide that certain returns should be accepted as filed. Under this procedure, some of the returns in our sample were restored to files and the remaining returns were available for examination. All of those returns were not examined; some were "surveyed" (not examined) because of resource constraints. We want to note, however, that if the statute of limitations has not expired, a return that had been accepted as filed during the classification process or surveyed at the group level can be examined at a later date if IRS becomes aware of the need for adjustments to the return. Such a situation could result from the examination of a corporation which produces adjustments that affect an individual's return.

To date, we have gathered most of the information you requested on the corporations and individuals, and we anticipate that we can provide a complete package to you by the end of June. We want to note that any information concerning the top 100 largest corporations and 100 wealthiest individuals is confidential and the disclosure thereof is regulated by Section 6103 of the Internal Revenue Code.

Sincerely,

Gayle Morin

Gayle G. Morin
Assistant to the Commissioner
(Legislative Liaison)

Chairman **Pickle**. Well, if my information is correct, I thought that we asked for that 2 months ago in anticipation of this hearing, just to kind of get a measurement of it—2 months ago. We just asked how many have not been audited and we have not been told yet.

Now, if that is a fact, why? And you are saying, you do not know. Well, I am going to assume that you have that list of 100 and we may add another 100 to it. But we are just trying to get an idea of what are you doing.

Mr. **Murphy**. Yes, sir.

Chairman **Pickle**. And so before the sun is down maybe you can tell us whether you have audited them. That should be a simple matter to tell us, would it not?

Mr. **Goldberg**. Yes, sir.

Chairman **Pickle**. All right, well, I hope we get that, because we are trying to find some answers on these things.

Now, I have got a lot of other questions, but I think in the interest of time, I am going to hear from another panel. I hope, Mr. Commissioner, if some of you leave that you have some of you stay here, stay longer, because we may want to ask questions of you from the next panel, their testimony. At least keep a representative here.

Can some of you stay for this now?

Mr. **Goldberg**. Yes, sir.

Before we close, I would like to express our support and encouragement for the roundtable approach you described. I think it will help us do our job better. I think it is very worthwhile and I think your efforts in the penalty reform area were good for everybody. We look forward to cooperating with you.

Chairman **Pickle**. All right, I hope something can come out of that or any other combination of it because we have got to do a better job and I think we could do a better job by coming together as a group and say, what is fair to the American taxpayer and that is what we are looking for.

Mr. **Goldberg**. Yes, sir.

Chairman **Pickle**. Thank you, very much, Commissioner for your testimony this morning.

[Additional questions for the record and IRS' responses follow:]

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June 4, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

I want to thank you for your testimony at the Oversight Subcommittee's hearing to examine the "tax gap" and taxpayer noncompliance. As the attached press release announces, I plan to follow-up and address tax gap issues through roundtable discussions with experts in the subject. Please provide me immediately with your suggestion of experts I should contact to participate in these meetings.

To complete our hearing record, I would appreciate receiving your responses to the following questions by June 22, 1990.

1. The tax gap will exceed $100 billion this year. However, this figure is somewhat misleading since it does not include: amounts in the accounts receivable inventory (i.e. the money owed by taxpayers but not paid); amounts owed from illegal activities like drug dealing; amounts owed relating to employment or excise taxes; or, the amount owed from any tax other than the Federal income tax. To what extent do the IRS tax gap estimates reflect the true amount of all taxpayer noncompliance?

2. Does the fact that the "tax gap" is limited to noncompliance in only the area of income tax suggest that the IRS's definition of the tax gap needs to be expanded? Shouldn't the definition of tax gap include all areas of taxpayer noncompliance with the tax laws? And if so, would the true size of taxpayer noncompliance exceed $200 billion?

3. How many billions of dollars in tax revenues does the government lose from illegal activities? How much is lost from the nonpayment of employment taxes? How much is lost from the nonpayment of excise taxes? How much is lost in the area of estate and gift taxes? Does the IRS have any estimates with regard to these categories? If not, why not?

June 4, 1990
Page Two

4. Why are the IRS's recent estimates so limited in scope? More importantly, why is it necessary to know the "net tax gap"?

5. Two years ago the IRS indicated that it was beginning a comprehensive review of its tax gap estimates. The purpose of this review was to identify areas not covered by its 1988 tax gap report. Where does the IRS stand with regard to this comprehensive review? What have you learned so far? What areas have you identified? When do you expect to issue compliance reports with regard to employment and excise taxes, and illegal source income?

6. There are other studies which measure taxpayer noncompliance. One such study, prepared by James S. Henry, states that each year's tax gap is really a continuing liability that the IRS is free to collect -- with interest -- whenever the IRS catches up with the noncompliant taxpayer. In the years since 1972, the cumulative present value of past tax gaps was estimated by the study at $1.6 trillion, an amount equal to about sixty percent of the entire Federal debt. Does the IRS measure the cumulative tax gap? Why or why not? What is the size of the cumulative tax gap? How much of this cumulative amount is still available for the IRS to collect?

7. Tax gap estimates whether "gross" or "net" are only as good as the information maintained by the IRS. To what extent is the IRS developing a data base that will permit a more comprehensive analysis of the tax gap components and development of solutions?

8. Of the $1 trillion collected by the IRS each year, almost 60% comes from individual and corporate income taxes. In other words, while $600 billion is voluntarily paid, more than $100 billion goes uncollected. The other 40% of total revenues comes primarily from employment taxes. What does the IRS know about employment tax noncompliance? Isn't this component which represents 40% of all taxes as important as income tax noncompliance?

9. The Administration has proposed a number of initiatives in fiscal year 1992 which would raise $3 billion in additional revenue. The initiatives would increase IRS activity in the areas of accounts receivable, small retirement plans, tax shelters, and large cases in Appeals. Which initiatives in the Administration's budget proposal will have the greatest impact on the "tax gap" and why?

10. The IRS had alternative estimates for 1987 which reduced the tax gap from $84.9 billion to $71.2 billion due to recommended tax assessments conceded in Appeals or lost in

litigation. The IRS is studying whether these amounts should cause the tax gap to be lower, particularly for large corporations. If the assessments are originally correct, why should their later concession lower estimates of taxpayer noncompliance? How much is lost in Appeals, litigation, and by virtue of management decisions not to pursue cases for other reasons such as to avoid the creation of precedent? How much is lost due to incorrect assessments by Examination?

11. The Oversight Subcommittee is aware that the IRS's net tax gap report encountered difficulty in getting cleared by OMB and Treasury. What were the problems with the IRS's original estimates? What changes did Treasury and OMB ask the IRS to make? Did the IRS make those changes?

12. Why did it take so long for the IRS to issue its net tax gap report? What problems did the IRS encounter in getting this report cleared? How difficult was it to arrive at these estimates?

13. What is the importance of the word "net"? Does it provide a clearer or more clouded portrait of taxpayer noncompliance?

14. Two years ago the IRS stated that the illegal sector by its very nature is a difficult area to improve noncompliance although the IRS will continue to maintain a substantial enforcement presence in this area. However, the IRS's own numbers indicate that overall criminal tax prosecutions have declined from 3,437 in 1978 to 3,044 in 1988. During this period, the number of tax returns and taxpayers have increased significantly. Why does the IRS sparingly use criminal prosecution to penalize noncompliance? How does the IRS expect to improve compliance in this area when its criminal presence is shrinking? To what extent are civil fraud penalties used to combat noncompliance? Do serious tax penalties have a deterrent effect on tax cheating?

15. According to IRS figures, general enforcement prosecutions are declining. These are criminal prosecutions of taxpayers with legal sources of income. These prosecutions have declined from 2,898 in 1978 to 1,383 in 1988. Indications are that a substantial number of these cases involve tax charges that have been added-on to charges involving other criminal behavior. Is there any general deterrence effect from prosecuting those involved in criminal activity such as drug dealers under the tax laws? Should criminal tax enforcement include prosecutions of individuals who are not otherwise involved in any criminal activity? Why or why not? Is the present level of general criminal tax enforcement sufficient to maintain or improve general compliance?

16. Unlike most kinds of illegal behavior, the Government's enforcement efforts to combat tax noncompliance remain confidential unless criminally prosecuted or civilly litigated. As a consequence, the risk of social stigmatization for even serious noncompliance is materially less than for other crimes. How can the visibility of IRS's noncompliance enforcement activities be increased? Does focusing attention on this subject increase or decrease overall compliance? What efforts can be taken to change social attitudes about tax cheating?

17. In the past six months, the Oversight Subcommittee has been contacted by several taxpayers who reported instances of tax fraud to IRS criminal investigators. In each case, the IRS failed to follow-up on these leads. Agents have told taxpayers that unless the matter involves drug dealing the IRS simply does not have the resources to track down their tips. Is this true? What should taxpayers do when they learn that others are not complying with the tax laws? What sort of response can they expect from the IRS? To what extent does the IRS pursue these tips? What are the difficulties in using informers? What improvements can be made in this area?

18. Some have suggested that to enhance compliance, the audit rate must be increased. Each year the IRS always submits proposed budgets which estimate audits rates higher than actually realized. The share of personal audits done on taxpayer premises fell to 24.7% from 33.3% in 1988. The number of returns audited slumped to 985,000 -- 0.92% of those filed. Audit rates fell for each major personal return category. What impact does the audit rate have on taxpayer compliance? What measures has the IRS taken to compensate for the steady decline in the audit rate?

19. The Oversight Subcommittee was told last year by the IRS that the tax gap, or compliance gap, involves the inability of people to comply, not unwillingness to comply, and that taxpayers need better information and better assistance. Last fall, during the fiscal year 1991 budget discussions, the IRS opposed the Administration's plan to charge a user fee for IRS telephone assistance in fiscal year 1992. A Treasury memorandum to OMB said the "Treasury will continue to work with vendors" to develop a program for the taxpayer service telephone user fee. Does the "other user fee" category of the Administration's budget include revenue from the telephone user fee in fiscal year 1992? Let alone the difficulty involved in charging taxpayers for assistance when

they stand a one-in-four chance of getting the correct answer, wouldn't this fee discourage taxpayers from seeking assistance and complying with the tax laws?

20. According to the Administration's budget, at the end of fiscal year 1991, there will be 34,200 cases awaiting an answer from the IRS technical function. This inventory will have increased 300% in two years. This is the area at the IRS that explains to taxpayers and IRS personnel how to interpret and apply the tax laws. Why has this increase happened? What impact does this background have on compliance? What advice do you give to IRS employees and taxpayers who are waiting for technical assistance?

21. What is the IRS's current position with regard to taxpayer amnesty?

22. What does the IRS think about allowing state governments to assist in the collection Federal income taxes?

23. To what extent does the IRS enter into information exchange agreements with state governments? Is this a cost-effective way to detect noncompliance?

24. The GAO report sets forth examples of ways taxpayers under report income. These include: building contractors who may not report all receipts from side operations like the sale of sand, bricks or used equipment; computer consultants who may not report fees from speaking engagements; or, sporting goods store owners who may not report receipts from equipment repairs, endorsements, or officiating. How does the IRS attack this underreported income problem? What more can be done to increase the reporting of this income? What are the IRS's views on increasing the scope of income withholding and expanded information reporting? To what extent is this under-reporting deliberate? How often is this behavior treated by the IRS as deliberate, criminal?

25. The GAO reports that deductions for cars and trucks, insurance, depreciation, and repairs are overstated to the greatest extent. Based on 1985 TCMP data, such deductions for cars and trucks were overstated by almost 16%. How constructive would simplification of these provisions be in promoting compliance? Do these provisions need to be simplified? Do taxpayers need more guidance? Are these kinds of deductions overstated because taxpayers simply do not understand what is required? Are there provisions in the tax code which are continually being abused by taxpayers? If so, which ones?

26. In recent months, the question of employers treating workers as independent contractors instead of workers has generated a lot of controversy. The distinction can mean a substantial difference in an employer's tax bill. In theory, the IRS should receive the same revenue regardless of how a worker is classified. What is the IRS doing with regard to the re-classification of independent contractors? To what extent are workers misclassified? How much money is at stake? How should this issue be addressed? What has been the impact of section 530 of the Revenue Act of 1978? To what extent can this issue be handled administratively? Is legislation required and, if so, what kind?

27. The Oversight Subcommittee understands that the IRS has completed a comprehensive study on the independent contractor issue. Please provide a copy of this report.

28. The IRS Collection function is using information returns to identify employees misclassified as independent contractors. Why is Collection doing the examinations?

29. Some have said that because the IRS audits only selected companies within an industry, the IRS is creating dichotomies in which businesses must count workers as employees while their unaudited competitors can treat similar workers as independent contractors. Can a test be developed which will provide a solution to this problem? Are similarly situated taxpayers being treated differently?

30. What programs does the IRS have to address noncompliance by sole proprietors? What programs does the IRS have on the drawing board?

31. The tax gap figures used in the GAO report do not take into consideration noncompliance by nonfilers. Recently, there has been a phenomenal growth in the number of extensions filed by taxpayers. The Commissioner's Advisory Group expressed concern in June 1989 that the IRS does not follow up when a taxpayer files for an extension but does not later file a return. The IRS confirmed it does not specifically follow-up. To what extent is nonfiling a problem? How much do nonfilers contribute to the tax gap? What programs does the IRS have to deal with nonfilers? What programs are on the drawing board? How should taxpayers who later voluntarily disclose to the IRS that they have not filed returns be treated?

32. The GAO reports that the IRS has been concerned about unreported income among fisherman. The IRS estimates the related annual tax loss to be about $125 million. The IRS

also has found cases where wage-earners, such as in the building trades, nurses, and seasonal workers, work on the side either to generate income that is easy to hide or to create business losses that can be used to lower the tax liability of their wages. How successful is the IRS in detecting this kind of noncompliance? Should the IRS coordinate with state and local governments to require proof of Federal tax filing before granting authorization to do business? Are there external information sources which would be helpful in curbing noncompliance? To what extent would expanding information reporting enhance compliance?

33. How easy is it for this type of under-reporting of income to go undetected and why? Do various schemes seem to be more local in scope? Do IRS districts tailor compliance projects to address local under-reporting schemes?

34. The Oversight Subcommittee has learned that IRS district offices employ local strategies to deal with this type of noncompliance. These local compliance initiatives are not, however, coordinated at the national level. Therefore, successful compliance efforts are employed throughout the country on an ad hoc basis. Why doesn't the IRS coordinate these local compliance efforts?

35. The IRS reports that only $700 million was lost in 1987 as the result of informal suppliers not filing income tax returns. How did the IRS arrive at this figure, particularly if taxpayers didn't file returns? Who are these taxpayers that don't file returns? To what extent are nonresident aliens part of this problem?

36. In 1988, the IRS Coordinated Examination Program's (CEP) national caseload included only 276 corporations that were ranked among the top 500 corporations in assets. Most of the other 224 corporations not included in CEP came from banking and finance industries. In 1988, the IRS completed examinations of 307 of the 1,461 corporations in CEP. Two thirds of the 307 cooperations accounted for $6.5 billion of the $8.9 billion in recommended taxes. Twenty-one petroleum and banking cases accounted for $2.5 billion. Exactly why were large corporations in the petroleum and banking industries responsible for the highest noncompliance? Why are so many banking institutions excluded from the CEP program? How many banks or financial institutions does the IRS audit each year?

37. It is admitted that about 70% of the recommended tax deficiencies proposed by Examination with regard to corporations are ultimately conceded by the IRS during the

administrative process. Do IRS auditors make erroneous determinations or do Appeals officers bargain away legitimate issues? Are corporations abusing the Appeals process?

38. The GAO indicates that large corporations with professional tax counsels have "aggressively used vagueness in the tax law" to reduce their tax liability. For instance, the GAO says corporations have claimed questionable research tax credits, taken duplicate deductions, and expensed instead of capitalized and depreciated assets. The IRS has had to contend with some issues year-after-year as companies repeat practices that have been previously raised in examinations. What can be done to curb these abuses? Are there sufficient sanctions to deal with this kind of corporate behavior? Do corporations continue to take aggressive positions knowing the IRS is incapable of handling sophisticated tax issues or will settle for less than what is actually due and owing?

39. Two years ago, the Oversight Subcommittee asked the IRS to identify noncompliant corporations and the issues in dispute. We asked what these corporations are doing that contributes to the tax gap (e.g. not filing returns, overstating deductions, not reporting income). The IRS maintained that this information was not available. Can the IRS answer these questions today?

40. With regard to corporations with assets over $250 million, examination coverage decreased from 78% in 1986 to 64% in 1988. Despite the decrease, the IRS recommended almost $1 billion more in taxes and penalties. If the examination program is the most effective way to pursue corporate noncompliance, why were audits cut?

41. The Oversight Subcommittee understands that the IRS is studying ways to better recover assessments from examinations that are appealed or litigated. In 1988 Tax Court cases, the IRS recovered 38% of the $1.1 billion in disputed taxes but only 30% of the $513 million disputed by those with assets over $50 million. What do the IRS's preliminary findings reveal? How successful is the IRS in court? Are IRS attorneys "outmanned and outgunned"? What do these court figures tell us about corporate behavior and IRS behavior?

42. Some have recommended that the IRS take additional steps to protect taxes owed by corporations that are going through bankruptcy because they do not pay what they owe. How serious is this problem? What needs to be done?

43. Some have recommended that the IRS take quicker action to collect taxes withheld from employees before the debt becomes unmanageable for the corporation. What is the IRS doing to improve controls over those who improperly use tax money they owe to bolster a failing business?

44. On November 15, 1989, the Oversight Subcommittee requested information on the IRS's "Compliance 2000" strategic initiative which was created in April 1988. Compliance 2000 is a planning strategy aimed at both revenue enhancement and closing the tax gap through enforcement and assistance programs. The Subcommittee asked very specific questions about the project and the compliance issues being discussed. On December 28, 1989, the IRS provided preliminary information on the project and indicated that the Compliance 2000 final report would be available by the end of March. On March 29, 1990, the IRS sent a follow-up letter providing a broad overview of the Compliance 2000 project.

    The Oversight Subcommittee has been trying to get information on this project for several months with little success. Why has the IRS failed to respond to our specific questions? Where is the final report? When will it be ready? Why is it taking so long to complete a project that was initiated more than two years ago? What problems has the project encountered in formulating a strategic plan for leading the IRS compliance activities into the future? What changes have been made to the report?

45. The honest taxpayers are bearing an ever-increasing burden because of the growing number of citizens who are not paying their full tax. As the honest taxpayer's burden increases, the growing inequity of the situation may convince them that they are paying an unfair share. This in turn, could motivate more of them to join that segment of society that is not paying what the law requires, and might ultimately lead to the breakdown of the voluntary compliance system itself. What factors or framework of issues should the Oversight Subcommittee consider in seeking ways to improve taxpayer compliance? Where can the most progress be made? Should these compliance issues be addressed through legislation, increased enforcement, and/or increased taxpayer education and assistance?

46. To what extent should the following recommendations be considered:

    Identify and propose changes to the tax law that promote simplification and fairness?

    Establish new techniques to detect unreported income?

Take steps to insure U.S. tax law compliance by nonresident aliens?

Streamline the process for collecting 100-percent penalties?

Explore ways to better use state tax information?

Pursue taxes owed by U.S. citizens living abroad who fail to file income tax returns?

Expand enforcement with increased emphasis on special compliance activities?

Improve the effectiveness, efficiency, and accuracy of automated compliance systems?

Improve the accuracy of the telephone assistance service?

Improve efforts to identify compliance in the nonfiler population and develop ways to identify nonfilers not covered by information return reporting?

Pursue criminal noncompliance in the legal sector through the Criminal Investigations Division General Enforcement Program?

Improve automated systems to identify returns with high audit potential?

Educate taxpayers to assist them in complying?

47. The GAO report (on page 105) provides a number of legislative proposals submitted by the IRS to Treasury and forwarded to Congress. Of the proposals for legislative change listed, which ones would be most constructive in terms of enhancing compliance?

As always, I appreciate your attention to this request. I look forward to working with you in seeking ways to improve compliance with our Federal tax laws. If you have any questions, please contact Rusty Guritz or Patrick Heck at 225-5522.

With warm regards, I am

Sincerely,

JJPickle

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/phl

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SENIOR DEPUTY COMMISSIONER

SEP 21 1990

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
House Committee on Ways and Means
1105 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your letter of June 4, 1990, I am enclosing responses to the follow-up questions from the April 19 hearing on the tax gap. In addition, I am enclosing a response to your August 16, 1990, letter in which you requested listing of problem areas and recommendations with respect to the tax gap and the accounts receivable inventory.

We look forward to working with you and your staff on the roundtable discussion on this issue. Should you have further questions, please let me know.

Sincerely,

Michael J. Murphy

Michael J. Murphy

Enclosure

1. **The tax gap will exceed $100 billion this year. However, this figure is somewhat misleading since it does not include: amounts in the accounts receivable inventory (i.e., the money owed by taxpayers but not paid); amounts owed from illegal activities like drug dealing; amounts owed relating to employment or excise taxes; or, the amount owed from any tax other than the Federal income tax. To what extent do the IRS tax gap estimates reflect the true amount of all taxpayer noncompliance?**

The gross tax gap is the amount of all tax liability that is not voluntarily paid. The concept includes all types of taxes. Our recent estimates, however, relate only to the legal-sector income tax gap. As we noted in our latest report, we are working on estimating the employment tax gap and illegal-sector income tax gap; we also have begun work on the excise tax gap.

Accounts receivable must not be confused with the tax gap. It includes interest and penalties, that are not a part of the tax gap, and does not include other things (such as amounts of noncompliance not detected by IRS) that are part of the tax gap. Also, the tax gap is a tax year concept; there is a gap associated with each tax year of liability. Accounts receivable, on the other hand, is an inventory relating to many tax years. The tax gap is analogous to an income statement item in a company's books while accounts receivable is analogous to a balance sheet item. Every tax amount in accounts receivable is part of a particular tax year's gross tax gap. They cannot be added on again.

2. **Does the fact that the "tax gap" is limited to noncompliance in only the area of income tax suggest that the IRS's definition of the tax gap needs to be expanded? Shouldn't the definition of the tax gap include all areas of taxpayer noncompliance with the tax laws? And if so, wouldn't the true size of taxpayer noncompliance exceed $200 billion?**

As we noted in our answer to Question 1, IRS does not limit its concept of the tax gap to the income tax component. We have labeled our estimates as "legal-sector income tax gap" estimates. Although our definition has always been all-inclusive, our ability to estimate has not. We have estimated only those portions of the tax gap where we have had reasonable data, and have consistently recognized the existence of the other components. We have begun collecting data for these other components, and plan to estimate these gaps in the next year or so, beginning with estimates of employment and excise taxes later this year.

Although we cannot be sure until we have conducted our research, we doubt that the other legal-sector components together are as large as the income tax component. Therefore, it is probably not appropriate to think of the legal-sector tax gap as being as large as $200 billion per year.

The estimates of the illegal-sector tax gap, by their nature, will always be very tentative. We do, however, plan to publish a report on the illegal-sector income tax gap later this year.

3. **How many billions of dollars in tax revenues does the government lose from illegal activities? How much is lost from the nonpayment of employment taxes? How much is lost from the nonpayment of excise taxes? How much is lost in the area of estate and gift taxes? Does the IRS have any estimates with regard to these categories? If not, why not?**

We do not have current estimates for these components of the tax gap. In 1983, we published partial estimates of the illegal-sector tax gap including amounts related to illegal drugs, illegal gambling, and prostitution. We estimated a gap for these activities for Tax Year 1981 of $9.0 billion.

We are working now to update our earlier estimates and to expand the scope of our estimates to include income from other illegal activities. We also plan to publish estimates of the employment and excise tax gaps later this year. Estate and gift taxes represent a small portion of overall taxes; we do not plan a separate study of those categories at this time.

4. **Why are the IRS's recent estimates so limited in scope? More importantly, why is it necessary to know the "net tax gap"?**

As we noted in our answers above, we have not had adequate data to estimate all components of the tax gap.

Our 1990 estimates of the net legal-sector income tax gap were in response to the Subcommittee's specific request at the March 1988 hearing. The value of the net tax gap estimates is that they indicate how much of the problem will remain after all current IRS enforcement activities run their course. They help us focus on the noncompliance that remains.

5. **Two years ago the IRS indicated that it was beginning a comprehensive review of its tax gap estimates. The purpose of this review was to identify areas not covered by its 1988 tax gap report. Where does the IRS stand with regard to this comprehensive review? What have you learned so far? What areas have you identified? When do you expect to issue compliance reports with regard to employment and excise taxes, and illegal source income?**

We plan to publish estimates of the employment and excise tax gaps later this year. We also plan to publish a report on the illegal-sector income tax gap this year.

In addition, the IRS has established special task forces to develop strategies for dealing with employment and excise tax non-compliance, especially the issues of independent contractors and misclassification of employees.

6. **There are other studies which measure taxpayer noncompliance. One such study, prepared by James S. Henry, states that each year's tax gap is really a continuing liability that the IRS is free to collect with interest whenever the IRS catches up with the noncompliant taxpayer. In the years since 1972, the cumulative present value of past tax gaps was estimated by the study at $1.6 trillion, an amount equal to about sixty percent of the entire Federal debt. Does the IRS measure the cumulative tax gap? Why or why not? What is the size of the cumulative tax gap? How much of this cumulative amount is still available for the IRS to collect?**

   IRS has not estimated the cumulative effect of past tax gaps. Although it is true that the gap is an annual phenomenon, it is important to understand what this cumulative estimate represents. This cumulative estimate of the gross tax gap represents the difference between total tax liability during the period and the amount that taxpayers paid voluntarily and on time against those liabilities. It does not take into account the amount IRS does collect, including interest and penalties. It also does not take into account amounts which are not collectible because the statutory period for assessment has expired, or because they cannot be realized through enforcement actions. For these reasons, it is misleading to represent a cumulative gross tax gap as an amount that the IRS is free to collect with interest whenever we catch up with the noncompliant taxpayer.

7. **Tax gap estimates whether "gross" or "net" are only as good as the information maintained by the IRS. To what extent is the IRS developing a data base that will permit a more comprehensive analysis of the tax gap components and development of solutions?**

   We are developing several new data sources for the purpose of making better tax gap estimates. For example, very little compliance data exist concerning large corporations or excise taxes, other than operational examination results. We are exploring alternative ways of supplementing these data--perhaps with TCMP-like studies. Other components of the tax gap--such as informal suppliers require special studies, and we will continue to conduct these to keep our data current. Finally, we are exploring ways of refining our method of estimating another key component of the tax gap that related to incomes not detected by TCMP. This may involve supplementing our existing data with additional information.

   As for data-related solutions to the tax gap problem, IRS has plans for a variety of systems modernization initiatives, which will help make important data readily available to enforcement and service personnel. One of the first such initiatives, Corporate Files On-Line (CFOL), began its initial implementation early in 1990. Its first stage of implementation placed taxpayers' entity information (names, addresses, and Social Security numbers) on-line, resulting in the reduction of unpostables and erroneous notices to taxpayers. In 1991, IRS will place tax module data in an on-line query-only environment, thereby reducing the need to retrieve taxpayers' returns. In 1992, third-party information documents (Forms W-2 and 1099) will be placed on-line. By having these data readily available, IRS will be able to determine more quickly and more accurately the correct amount of tax owed by taxpayers. For example, if an examiner determines that additional tax is owed for one year, the previous two years could be checked to see whether the taxpayer made the same mistake earlier. CFOL will also allow IRS to cross-reference quickly such things as alimony income, dependents' exemptions, partnership income, interest and dividend income, and taxpayers' and employers' entity data each of which could be done for multiple tax years.

8. **Of the $1 trillion collected by the IRS each year, almost 60% comes from individual and corporate income taxes. In other words, while $600 billion is voluntarily paid, more than $100 billion goes uncollected. The other 40% of total revenues comes primarily from employment taxes. What does the IRS know about employment tax noncompliance? Isn't this component which represents 40% of all taxes as important as income tax noncompliance?**

The $600 billion includes amounts of tax, penalties and interest that IRS collects through its enforcement efforts; it is not all voluntarily paid. The $100 billion or so tax gap represents tax only and a portion of that is collected through our enforcement activity. Enforcement revenues from individual and corporate income taxes are included in the $600 billion collected. Similarly, the remaining $400 billion or so includes both voluntary payments on current liabilities, and enforcement revenues from past liabilities.

Since we have not yet completed our study of employment tax noncompliance, we cannot say how large that component of the gap is. Although this is certainly an important area of noncompliance, the employment tax gap is not likely to be anywhere near as large as the income tax gap, even in percentage terms. This is because of the nature of employment tax noncompliance; much of it arises from employers not withholding the tax or not remitting what they do withhold, and it is often much easier to detect than income tax noncompliance.

9. **The Administration has proposed a number of initiatives in fiscal year 1992 which would raise $3 billion in additional revenue. The initiatives would increase IRS activity in the areas of accounts receivable, small retirement plans, tax shelters, and large cases in Appeals. Which initiatives in the Administration's budget proposal will have the greatest impact on the "tax gap" and why?**

All of the initiatives in our 1991 budget submission will bring in additional dollars to address the gross tax gap. The initiative to collect unpaid taxes will yield the most dollars, $1.6 billion over the life of the initiative. Other initiatives yielding $1 billion or more are: Examination Field Audits ($1.1 billion), Examination Correspondence Audits ($1 billion), and Returns Processing Pre-1985 Non-Custodial Agreement Initiative ($1 billion).

10. **The IRS had alternative estimates for 1987 which reduced the tax gap from $84.9 billion to $71.2 billion due to recommended tax assessments conceded in Appeals or lost in litigation. The IRS is studying whether these amounts should cause the tax gap to be lower, particularly for large corporations. If the assessments are originally correct, why should their later concession lower estimates of taxpayer noncompliance? How much is lost in Appeals, litigation, and by virtue of management decisions not to pursue cases for other reasons such as to avoid the creation of precedent? How much is lost due to incorrect assessments by Examination?**

An adjustment was made to the tax gap computation to reflect the difference between tax deficiencies initially determined by Examination on cases with $100,000 or more in dispute and the final deficiencies assessed after consideration of the case by Appeals or the results of litigation. It is important to distinguish between proposed additional taxes which are in dispute, versus assessments determined after the conclusion of the dispute resolution process. It was concluded that the latter figure, reflecting the amount of tax deficiencies resulting after all recourse to Appeals and litigation are concluded, is a more accurate measure of taxpayer noncompliance.

The question as to amounts "lost" in Appeals or in litigation tends to distort the nature of the examination and dispute resolution process, and the Service's duty in executing compliance programs. The Service is required under the Internal Revenue Code to audit returns for accuracy, substantiation, and to ensure that positions claimed on returns properly interpret the tax laws as intended by Congress.

A taxpayer may fail to substantiate an item on examination, which may result in disallowance and a resulting proposed deficiency. If the taxpayer exercises his right to appeal the deficiency to Appeals, and ultimately produces adequate substantiation, the proposed deficiency will be conceded by Appeals. However, such amount is not "lost"; rather, Appeals is fulfilling its mandate to see that only the correct deficiency is determined. While there are, of course, instances where cases are conceded because of an incorrect determination by Examination, the Service does not maintain statistics as to what portion of case concessions is attributable to "incorrect" determinations by Examination, inasmuch as usually there are multiple factors which go into the settlement process, such as uncertainty as to the facts or law.

11. **The Oversight Subcommittee is aware that the IRS's net tax gap report encountered difficulty in getting cleared by OMB and Treasury. What were the problems with the IRS's original estimates? What changes did Treasury and OMB ask the IRS to make? Did the IRS make those changes?**

As is typical with reports of this nature, drafts of the net tax gap report were discussed with Treasury since the report covered policy and revenue issues. There were no substantive disagreements with the drafts.

12. Why did it take so long for the IRS to issue its net tax gap report? What problems did the IRS encounter in getting this report cleared? How difficult was it to arrive at these estimates?

There are three technical reasons for the delay:

a. We had finalized an earlier version of the report over a year ago, but just as we were preparing to print it, we discovered in a concurrent study that the data we had used to translate examination recommendations into eventual revenue collected was significantly out of date. The net tax gap estimating process was put on hold while this other study developed an "interim" method for making these estimates. That study was completed last November (1989).

b. Once we were able to apply this "interim" method, enough time had lapsed that we had an additional fiscal year's worth of enforcement data upon which to base our estimates. We decided to re-estimate the enforcement revenues using the up-to-date information.

c. We are serious about answering the question, "What is the maximum amount of the tax gap that IRS could collect cost-effectively by expanding its enforcement programs?" We spent a considerable amount of time trying to estimate this, but found that any estimate we came up with was seriously incomplete in many respects. We finally decided not to include such estimates in this report.

13. What is the importance of the word "net"? Does it provide a clearer or more clouded portrait of taxpayer noncompliance?

The term "net" means net of enforcement revenue. The net tax gap, therefore, is the portion of the gross tax gap that will remain uncollected after present and planned enforcement efforts have been completed. The size of net tax gap (relative to the gross tax gap) reflects the extent to which we are collecting the tax gap. The distribution of the net tax gap guides us in understanding which areas of noncompliance might be best suited for additional enforcement activities. Neither the size nor the distribution of the net tax gap gives us a complete "portrait" of taxpayer noncompliance; that is the purpose of the gross tax gap.

14. **Two years ago the IRS stated that the illegal sector by its very nature is a difficult area to improve noncompliance although the IRS will continue to maintain a substantial enforcement presence in this area. However, the IRS's own numbers indicate that overall criminal tax prosecutions have declined from 3,437 in 1978 to 3,044 in 1988. During this period, the number of tax returns and taxpayers have increased significantly. Why does the IRS sparingly use criminal prosecution to improve compliance? How does the IRS expect to improve compliance in this area when its criminal presence is shrinking? To what extent are civil fraud penalties used to combat noncompliance? Do serious tax penalties have a deterrent effect on tax cheating?**

The Service's criminal presence as measured in the number of special agent staff years realized has increased over the last five years. As the chart below shows, both the special enforcement and general enforcement programs have grown since 1985. During this time, the nature and complexity of financial crimes has changed dramatically. As taxpayers elevate the level of sophistication of their evasion schemes, it requires an equal increase in special agent expertise and resources. Therefore, the number of prosecutions has declined slightly while the staffing has increased.

S/A Staffyears	**1985**	**1986**	**1987**	**1988**	**1989**
General Enforcement	1477	1452	1362	1458	1506
Special Enforcement	1344	1348	1353	1420	1489
Total	2821	2800	2715	2878	2995

The actual deterrent effect of our criminal prosecutions may be immeasurable. Criminal Investigation has experienced numerous high-impact prosecutions during recent years in both the general and special enforcement programs. This noticeable increase in publicity should have a deterrent effect and increase tax compliance.

Civil fraud penalties were assessed against approximately 10,000 taxpayers in each of the years 1983 through 1988. Net assessments totalled $528 million. Our research indicates that a significant segment of the taxpaying population considers the threat of this penalty a valid deterrent. As you know, we conducted an extensive study of the penalty system in 1988 which culminated in the report issued at your February 22, 1989 hearing on civil penalties. Among the conclusions reported was that the presence of a penalty must be coupled with the probability that the violation would be caught to be useful as a deterrent. Therefore, resources sufficient to establish a reasonable presence in the system are as important as the level of the penalty in maintaining the effectiveness of the civil fraud penalty.

15. **According to IRS figures, general enforcement prosecutions are declining. These are criminal prosecutions of taxpayers with legal sources of income. These prosecutions have declined from 2,898 in 1978 to 1,383 in 1988. Indications are that a substantial number of these cases involve tax charges that have been added-on to charges involving other criminal behavior. Is there any general deterrence effect from prosecuting those involved in criminal activity such as drug dealers under the tax laws? Should criminal tax enforcement include prosecutions of individuals who are not otherwise involved in criminal activity? Why or why not? Is the present level of general criminal tax enforcement sufficient to maintain or improve general compliance?**

As we noted above, part of the decrease in general enforcement prosecutions is due to the increasing complexity of financial crimes and investigations. The decrease also reflects a shift towards more special enforcement prosecutions. General enforcement program prosecutions usually do not involve tax charges added on to other criminal charges. We believe that the threat of sanctions, whether criminal prosecution or imposition of a civil fraud penalty is an important deterrent to non-compliance. Therefore we will continue to balance our criminal prosecutions between cases involving other criminal activity as well as general tax prosecutions.

16. **Unlike most kinds of illegal behavior, the Government's enforcement efforts to combat tax noncompliance remain confidential unless criminally prosecuted or civilly litigated. As a consequence, the risk of social stigmatization for even serious noncompliance is materially less than for other crimes. How can the visibility of IRS's noncompliance enforcement activities be increased? Does focusing attention on this subject increase or decrease overall compliance? What efforts can be taken to change social attitudes about tax cheating?**

While we do not publicize the names of taxpayers involved in civil enforcement proceedings, we publicize those who are criminally prosecuted or civilly litigated. IRS also publicizes areas/issues of noncompliance that have been targeted for enforcement activities, as well as income ranges of taxpayers and enforcement activities targeted for each of those income ranges. During the course of our collection activities, some information about delinquent taxpayers becomes a matter of public record, when we file a notice of federal tax lien, for example. This public information is sometimes picked up by credit bureaus and news media. Furthermore, taxpayers who have been audited or involved in collection activity will on their own accord discuss the matter with friends and neighbors. Though it is difficult to quantify, we feel that both types of publicity impact on voluntary compliance. Tax administrators and researchers generally believe that there is a multiplier effect on compliance from compliance enforcement activities. Furthermore, there is some data that suggests that there is a deterrent effect stemming from an awareness of an enforcement presence, i. e., a probability of being "caught" if one is not compliant.

Changing social attitudes is complex, but we can only hope to retain popular support for our system of voluntary compliance if the taxpaying public perceives the IRS to be fair and even-handed in its approach to tax administration. The protections contained in the Taxpayer's Bill of Rights ensure that citizen's rights will be respected, laying the foundation for a fair and equitable tax system.

17. **In the past six months, the Oversight Subcommittee has been contacted by several taxpayers who reported instances of tax fraud to IRS criminal investigators. In each case, the IRS failed to follow-up on these leads. Agents have told taxpayers that unless the matter involves drug dealing the IRS simply does not have the resources to track down their tips. Is this true? What should taxpayers do when they learn that others are not complying with the tax laws? What sort of response can they expect from the IRS? To what extent does the IRS pursue these tips? What are the difficulties in using informers? What improvements can be made in this area?**

The IRS will investigate and prosecute instances of tax fraud that do not involve other criminal activity. The Service receives thousands of information items each year both directly from the public and from our other public contact functions. Criminal Investigation is mandated to evaluate every information item, but, because of limited resources, only those with the greatest potential are developed into full scale investigations. Many of the leads that do not warrant criminal investigation are referred to Examination or Collection for possible civil action.

Taxpayers should continue to report suspected violations of the tax laws to the IRS. While taxpayers may expect to see immediate action on their information, due to the volume of work in our enforcement functions, there is often a considerable lapse of time between the time we receive the information and when noticeable action, civil or criminal, occurs.

There are difficulties in using informants. We recognize that improvements in this area are possible and have reviewed and revised our procedures. We have revised the Internal Revenue Manual to update the factors that District Directors should consider in evaluating the use of an informant. We also require that Criminal Investigation Division Chiefs review all open informant files annually and report significant developments to the District Director.

18. **Some have suggested that to enhance compliance, the audit rate must be increased. Each year the IRS always submits proposed budgets which estimate audit rates higher than actually realized. The share of personal audits done on taxpayer premises fell to 24.7% from 33.3% in 1988. The number of returns audited slumped to 985,000 -- 0.92% of those filed. Audit rates fell for each major personal return category. What impact does the audit rate have on taxpayer compliance? What measures has the IRS taken to compensate for the steady decline in the audit rate?**

The impact of changes in the audit coverage rate on voluntary compliance is referred to as the indirect revenue effect of examinations or so-called "ripple effect", i,e, the change in voluntary compliance among those who have not been examined that arises from a change in the audit coverage rate. There is no consensus among researchers as to the magnitude of this indirect effect, but most agree that it is significant and positive. The FY 1991 Examination plan, expands coverage in the low compliant tax gap areas. Additionally, as part of our strategic management process, management goals have been set which will result in increased coverage in the individual and corporate areas.

19. **The oversight Subcommittee was told last year by the IRS that the tax gap, or compliance gap, involves the inability of people to comply, not unwillingness to comply, and that taxpayers need better assistance. Last fall, during the fiscal year 1991 budget discussions, the IRS opposed he Administration's plan to charge a user fee for IRS telephone assistance in fiscal year 1992. A Treasury memorandum to OMB said the "Treasury will continue to work with vendors" to develop a program for the taxpayer service user fee. Does the "other user fee" category of the Administration's budget include revenue from the telephone user fee in fiscal year 1992?**

No, there are no revenues from a telephone user fee in the President's budget.

20. **According to the Administration's budget, at the end of fiscal year 1991, there will be 34,200 cases awaiting an answer from the IRS technical function. This inventory will have increased 300% in two years. This is the area at the IRS that explains to taxpayers and IRS personnel how to interpret and apply the tax laws. Why has this increase happened? What impact does this background have on compliance? What advice do you give to IRS employees and taxpayers who are waiting for technical assistance?**

The ending inventory estimate of 34,200 appears in the FY 1991 Congressional Budget Submission and due to an internal reorganization in October, 1988, the closure estimates for FY 1991 and FY 1992 were substantially understated. The FY 1992 budget submission has revised the receipt, closure and ending inventory figures. Closures have been projected to be in the range of 22,500 for FY 1990 through FY 1996 and are based on the actual closures for FY 1989. Using these new projections, the ending inventory for FY 1991 is estimated to be 13,700.

The Associate Chief Counsel (Technical) is currently evaluating the letter ruling program to devise ways to increase efficiency and timeliness. A number of changes in procedures should be forthcoming. We anticipate these changes will increase the rate of closures and decrease the ending inventory.

21. **What is the IRS's current position with regard to taxpayer amnesty?**

For a number of years IRS has consistently held the view that a general tax amnesty would be ill-advised and counter-productive. That position has not changed. In the context of the tax gap, however, IRS continues to review various segments of the tax gap and areas of non-compliance. It is our belief that targeted penalty relief, as an adjunct of a broad-based, long-term strategy to improve tax administration, may be a viable option.

22. **What does the IRS think about allowing state governments to assist in the collection of Federal income taxes?**

The IRS has recently given serious consideration to this idea. We also understand that some of the larger states have publicly commented on the potential benefits of such a course of action. New York State has indicated opposition to the idea because it is unnecessary, given the high degree of cooperation between state and federal tax administrations and because it may raise conflicts between a state tax agency's duties to enforce state tax laws and the possibly conflicting incentive to provide services to the IRS. While California has publicly supported the concept, in doing so, they have noted that certain problems of taxpayer rights and collection powers would need to be addressed.

Some permutations of this proposal may be feasible. For example, it might be possible to work out agreements under which a state would collect both federal and state liabilities at the same time where a taxpayer has a liability for both taxes (FUTA is one example). Similarly, the IRS could collect both taxes at the same time. However, there are a number of issues that would have to be addressed either statutorily or administratively before this process could be effected, including the following:

> Disclosure: Section 6103 might have to be amended to resolve problems of limitations on states to make investigative disclosures of information received from federal tax files, and to clarify the restrictions and limitations of that section as they would be applicable to collection situations.
>
> Jurisdiction: Under some proposals, the assigned tax agency (state or federal) would examine both the state and federal returns and make appropriate adjustments. Who, however, gives the taxpayer notice of the deficiency? What court has jurisdiction to hear an appeal? Would the case have to be split after audit but before appeal?
>
> Coordination: The fifty states have widely differing rules of procedure and litigating policies, which also may differ from those applied by the IRS. These differences might lead to significant differences in how taxpayers with similar tax debts are treated in different parts of the country. Would the Taxpayer Bill of Rights apply to federal tax debts being collected by a state tax agency? If so, from whom would the taxpayer collect administrative and/or litigation costs under section 7430, the State or the Federal Government?

These are just some of the issues which would have to be addressed in crafting this type of proposal. Depending upon the specifics of any proposal, other issues might easily surface. In any event, we do believe that any transfer of collection authority for federal taxes to the states would require legislation, and could not be done administratively.

23. **To what extent does the IRS enter into information exchange agreements with state governments? Is this a cost-effective way to detect non-compliance?**

Currently there are approximately 100 information exchange agreements in place between the IRS and state tax agencies. Every state is covered by some agreement. Activity under the agreements varies and definitive figures as to the benefits of these programs have not been compiled. We believe, however, that these agreements are a cost-effective way to detect non-compliance.

24. **The GAO report sets forth examples of ways taxpayers under-report income. These include: building contractors who may not report all receipts from side operations like the sale of sand, bricks or used equipment: computer consultants who may not report fees from speaking engagements, or, sporting goods store owners who may not report receipts from equipment repairs, endorsements, or officiating. How does the IRS attack this underreported income problem? What more can be done to increase the reporting of this income? What are the IRS's views on increasing the scope of income withholding and expanding information reporting? To what extent is this under-reporting deliberate? How often is this behavior treated by the IRS as deliberate, criminal?**

IRS attacks underreported income in a number of ways. One is by information gathering projects (IGPs) which are studies undertaken to identify non-compliance within an occupation, an industry, a geographical area, or a specific economic activity. Another way is by examining individual returns. When examining taxpayers with a high potential for unreported/underreported income, such as those who deal primarily in cash, examiners are trained to use various auditing techniques to identify additional income. The examiner probes for unreported/underreported income, and when appropriate, uses indirect methods to detect income discrepancies.

In conjunction with the Department of the Treasury, we are currently exploring possible areas for improving compliance through simplification of tax rules and other changes. We are also focusing on improving payer compliance with filing information returns which would improve our ability to detect underreported income through our matching program.

Fraud referrals are made in cases where it is determined there was fraudulent intent for not reporting the income. Most fraud referrals are based on underreported or unreported income. Of the total fraud referrals in FY 1989, approximately 30 percent were referred for criminal consideration; the remaining were referred for consideration of the civil fraud penalty.

25. **The GAO reports that deductions for cars and trucks, insurance, depreciation, and repairs are overstated to the greatest extent. Based on 1985 TCMP data, such deductions for cars and trucks were overstated by almost 16%. How constructive would simplification of these provisions be in promoting compliance? Do these provisions need to be simplified? Do taxpayers need more guidance? Are these kinds of deductions overstated because taxpayers simply do not understand what is required? Are there provisions in the tax code which are continually being abused by taxpayers? If so, which ones?**

We do not have any data which identifies the causes for the overstatement of these expenses. However, we believe that it is probably due to a combination of factors, i. e., complexity of the law which includes the record keeping requirements that are needed to arrive at the proper deduction, social attitudes among some that it is acceptable to overstate these deductions, and in some instances, taxpayers are playing the "audit lottery."

Since the causes for the noncompliance are varied, the solutions would also have to be varied. That is, simplification of the law and thus, the record keeping requirements would address one cause of the noncompliance. In addition, additional taxpayer assistance and guidance along with increased enforcement would also be needed to address other causes of non-compliance.

26. **In recent months, the question of employers treating workers as independent contractors instead of workers has generated a lot of controversy. The distinction can mean a substantial difference in an employer's tax bill. In theory, the IRS should receive the same revenue regardless of how a worker is classified. What is the IRS doing with regard to the re-classification of independent contractors? To what extent are workers misclassified? How much money is at stake? What has been the impact of section 530 of the Revenue Act of 1978? How should this issue be addressed? To what extent can this issue be handled administratively? Is legislation required and, if so, what kind?**

As the result of a study which began in July 1984, the IRS implemented a nationwide Collection program during 1986 expanding employment tax examinations in the area of worker misclassification. Collection's program, focusing primarily on small to medium size businesses, is an adjunct to the Examination function's continuing involvement with employment tax examinations. Also, a multi-functional task force has been charged with examining the "tax gap" as it relates to issues involving classification of workers as employees or independent contractors.

In May of 1989, we estimated that $10.335 billion was lost for tax years 1984-1989 due to misclassification of workers as independent contractors. Specifically, for tax year 1989, we estimated the revenue loss due to misclassification to be $1.886 billion, of which $146 million is directly attributable to Section 530 of the revenue act of 1978. Thus, based on an average of the 1984 and 1989 figures, the total withholding tax gap for the six year period beginning in 1984 is estimated to be $10.335 billion, of which, $771 million is estimated to be directly attributable to Section 530.

Although IRS will continue its efforts to ensure compliance with employment tax rules, specifically as they relate to classification of workers, a legislative solution may be appropriate. The IRS would be happy to work with the Department of the Treasury and with the Congress to provide the information needed to determine whether a statutory change could effectively address non-compliance with employment tax requirements.

27. **The Oversight Subcommittee understands that the IRS has completed a comprehensive study on the independent contractor issue. Please provide a copy of this report.**

Attached is a copy of a report on The Strategic Initiative on Withholding Noncompliance (SVC-1) dated June, 1989. In addition, IRS has continued to look at this issue and will provide further information to the Committee after review by the Department of the Treasury.

STRATEGIC INITIATIVE ON WITHHOLDING NONCOMPLIANCE (SVC-1)

EMPLOYER SURVEY

REPORT OF FINDINGS

Compliance Measurement Group
Research Division

June 1989

Summary

The SVC-1 employer survey examined employment tax and withholding compliance for businesses with an employer's quarterly federal tax filing requirement in tax year 1984. This report presents findings of the employment tax and misclassified employee portions of the survey. Underwithholding of income tax, and FICA and FUTA underpayment are found to be $3.5 billion in tax year 1984. This indicates a substantial revenue loss as well as a significant contribution to balance due returns and subsequent collection efforts. Misclassification of employees is found to occur with 1 in 7 employers. These workers account for $16 billion in compensation. Of those employers who misclassify their employees, 9 percent have section 530 protection. These employers account for 14 percent of misclassified compensation. Since the survey does not include employers who are completely noncompliant with employment tax regulations, the estimates of underwithholding and nonpayment presented here are conservative.

Introduction

The Strategic Initiative to Establish a Research Project on Withholding Noncompliance (SVC-1) is a multifunctional effort to address the extent and causes of noncompliance in the withholding area and to make recommendations for improving the effectiveness of tax administration. As part of SVC-1, the employer survey measures employer compliance with the following employment tax reporting requirements: employment tax returns, W-4 submittals, employee versus independent contractor classification, and compliance of U.S. citizens claiming exemption from withholding on foreign income. Other SVC-1 surveys address tax compliance of those employed by firms in the employer survey, W-4 filing patterns, characteristics of W-4 filers, agricultural withholding and foreign withholding systems.

The employer survey measured employment tax compliance and withholding-related data for 3331 employers. This established per return and per exam wage and tax data for unemployment tax and quarterly employer's tax returns. The information from the survey has been used to estimate voluntary reporting percentages for wages, withholding, and unemployment and social security taxes. The W-4 section of the survey determined compliance of employers with Form W-4 submittal requirements. The employer/independent contractor section established the number of workers who should be treated as employees under common law rules, but were treated by their employers as independent contractors. The FICA (Federal Insurance Contribution Act) tax and FUTA (Federal Unemployment Tax Act) tax assessments on that misclassified income are also determined. The revenue impacts associated with misclassified income will be determined with data from both the employer and misclassified employee survey. The final portion of the survey ~~identified~~ employees who claimed, under section 911, exemption from income tax withholding on foreign earned income.

This report addresses the employment tax and misclassified employee sections of the employer survey. The section on W-4 compliance is addressed in "Form W-4 Compliance: Evidence From Survey Data and Returns Processing" in Trend Analyses and Related Statistics, 1989 Update (Document 6011), which will be released by the Research Division in July, 1989. The section on foreign earned income is addressed in Study of Employees Who Claim Exemption From Withholding Due to IRC Section 911 which was completed by the Office of the Associate Commissioner, International in January 1989.

The Employer Survey

The survey covered 3,331 employers who were selected from those who had a Form 941/Form 941E filing requirement on the business master file (BMF) for tax year (TY) 1984. Form 941 is the Employer's Quarterly Federal Tax Return. State and local governments and other employers who only withhold income tax file Form 941 E, Quarterly Return of Withheld Federal Income Tax. These filers do not pay FUTA tax and do not withhold social security taxes. The sample does not include organizations with no employees and those that were legally required to file a Form 941 or Form 941E in 1984, but did not have a record on the BMF. The survey, which was conducted from June 1986 through May 1987, established employment tax and related data for tax year 1984. The sample represents approximately 5.15 million employers and was selected from all industries and large and small employers within each industry. In addition to employment tax return information, examiners were provided with a list of employees for whom the employer submitted a Form W-2 in 1984. The results presented here are weighted to represent values for the entire population of 5.15 million employers. The checksheet used in the survey is contained at the end of this report.

Employment Taxes and Withholding Compliance

The employer survey indicates the level of reporting for wages, FUTA, FICA and income tax withholding. FUTA obligations are estimated to exceed payments by $196 million. Withholding of income taxes is estimated to be deficient by $1.6 billion. Underpayment of social security taxes is estimated at $1.7 billion. The total deficiency (income tax, FUTA and FICA) is $3.5 billion for tax year 1984.

The employment tax section of the employer survey establishes per return and per exam magnitudes for payment, wage and tax data for Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return and Form 941, Employer's Quarterly Federal Tax Return. Amounts reported in the survey are those for the entire year and return amounts reflect amended returns, if they had been filed prior to the SVC-1 examination.

Table 1 presents wage and tax reporting amounts from the survey. For all employers subject to unemployment taxes, payments to individuals for services are reported on Form 940. Underreporting of payments for services is found to be $16.955 billion. This is mostly compensation of misclassified employees that was not reported as wage income. Form 940 taxable wages are found to be underreported by $8.149 billion in TY84. The difference between Form 940 payments and taxable wages is due to exclusions. The primary exclusion is for payments over $7,000 per individual that are not subject to FUTA tax. Form 940 FUTA tax is estimated to be underreported by $196 million. These amounts are due to both federal and state governments. The actual breakdown between these levels of government depends on the unemployment compensation experience in each state.

Form 941 taxable wages are estimated to be underreported by $16.106 billion in TY84. This includes all wages subject to income tax withholding. Form 941 income tax is estimated to be underwithheld by $1.582 billion. Underreporting of Form 941 social security wages is estimated to be $12.661 billion. At 1984 FICA rates (13.7 percent of wages), this translates to a $1.735 billion underpayment of FICA taxes. Form 940 penalties on initial taxpayer reported amounts are estimated to be $72 million. The survey determined that Form 940 penalties should have been $86 million per return. Form 941 penalties on taxpayer reported compensation are estimated to be $1.393 billion. The employer survey determined that they should have been $1.592 billion.

Table 1. Employment Tax Reporting and Voluntary Reporting Percentages (VRP)

Item	(1) Per Return ($ millions)	(2) Per Exam ($ millions)	(3) Unreported (2)-(1) ($ millions)	(4) VRP (1)/(2)
Form 940 Payments for Services	1,226,872	1,243,827	16,955	98.6
Form 940 Taxable Wages	508,677	516,826	8,149	98.4
Form 940 Total FUTA Tax	5,413	5,609	196	96.5
Form 940 Penalties	72	86	14	
Form 941 Wages	1,715,330	1,731,436	16,106	99.1
Form 941 Income Tax Withheld	243,540	245,122	1,582	99.4
Form 941 Taxable FICA Wages	985,788	998,449	12,661	98.7
Form 941 Penalties	1,393	1,592	199	

Voluntary reporting percentages (VRP) are established from amounts per return divided by amounts per exam. VRPs, as reported in Table 1, exceed 96 percent for all employment tax items measured in the employer survey. Reporting percentages exceed 90 percent in all industries. Thus, there do not appear to be any industries that exhibit substantially more noncompliance in employment tax reporting. Although reporting percentages are over 90 percent, the underwithholding and underpayment of taxes represents a revenue loss in excess of $2 billion. This consists of income tax underwithholding of $1.6 billion and FUTA and FICA withholding underpayments of $196 million and $1.7335 billion respectively. Underwithholding does not directly result in a loss to the U.S. Treasury. Some income that is not reported on employment tax returns is undoubtedly reported on individual returns. However, even if all of this income were reported, underwithholding increases the number and size of balance due returns and contributes to subsequent collection efforts. Since nonfilers are not included in the sample, VRP's reported here, most likely, overestimate compliance levels for all employers.

Misclassified Employees

This section of the employer survey established the extent to which employers have erroneously treated their employees as independent contractors. Under section 530 of the Revenue Act of 1978, employers are not liable for employment taxes if there was a reasonable basis for treatment of workers as independent contractors. The employer survey establishes that about 1 in 7 employers misclassified their workers in TY84. An estimated 3.4 million misclassified employees received $16 billion in compensation in tax year 1984. The survey also establishes that 9 percent of employers who misclassified their employees qualified under the section 530 safe haven provisions. Misclassification appears to be concentrated among small employers and service firms.

The classification of a worker as an employee or an independent contractor for tax purposes is determined by a common law test. Generally, an employment relationship exists if the recipient of the service has control of the means by which the work is accomplished as well as the results of the work. If there is a reasonable basis for treatment of a worker as an independent contractor, then the taxpayer may qualify for protection from employment tax assessments and penalties under Section 530 of the Revenue Act of 1978. To qualify for a safe haven, an employer must have filed all returns (including information returns) and treated the workers' employment status consistently. Section 530 relief applies only to those workers for whom information returns were filed and the class of workers who were consistently treated as independent contractors. The primary safe havens are prior IRS audit and industry practice. Safe haven status may also be established by a court precedent. The prior IRS audit can include an employment, income, excise or employer plan/exempt organization examination which resulted in no assessment attributable to the taxpayer's employment tax treatment of individuals. The Service makes some adjustments based on information returns matching. These adjustments are not considered to be an audit for Section 530 purposes. The industry practice provision establishes a safe haven if workers in similar positions are treated as independent contractors in the taxpayer's industry.

Employer assessments for FICA tax, FUTA tax and income tax withholding on compensation of misclassified employees, as determined by Sections 3509, 3121 (d)(3) and 3402 (d) of the Internal Revenue Code, were also established in the survey. The amounts reported here do not equate to lost tax revenues. A portion of this compensation was reported by individuals, even though there is no withholding. The extent of reporting of this compensation was determined in the misclassified employee survey.

Workers whose employers receive relief under section 530 are only liable for the employee's portion of the FICA tax and are not liable for SECA taxes. In practice, many of these individuals report their compensation as self-employment income and deduct employment related expenses from compensation. It is expected that in most cases, the correct treatment of social security taxes (the employee share of FICA) would result in an increase in tax liability for those who have paid SECA.

Table 2 reports the number of employers, workers, compensation and taxes associated with misclassification. This is presented for those who could be reclassified, those who could not be reclassified under Section 530 and for the two groups combined. These data indicate that Section 530 protects 307,014 workers of 70,220 employers. It is estimated that 3,084,742 workers of 692,488 employers were subject to reclassification. Thus, 9 percent of misclassified workers fall under the section 530 Safe Haven provisions.

Under section 1706 of the tax Reform Act of 1986, section 530 relief is no longer available to employers who provide certain technical personnel to clients. This type of worker makes up .4 percent of the misclassified workers identified in the employer survey. Thus, it appears that section 1706 has had a minimal effect on the extent of section 530 protection.

A majority (56.1 percent) of reclassified workers provide services for those with 1 to 99 employees. These employers account for only 32.8 percent of Forms W-2 as reported in the employer survey. Service firms account for 18.9 percent of all reclassified workers, while the employer survey indicates that they account for 10 percent of Forms W-2.[1] Small employers also account for a large percentage of workers who would have been reclassified, except for Section 530. Firms with 1 to 9 employees account for 32.5 percent of Section 530 workers. This same group accounts for 10.6 percent of Forms W-2. Service firms account for 40.5 percent of the 307,014 workers who are exempt from reclassification due to Section 530. Thus, it appears that service firms and small employers are more likely to misclassify their employees than employers as a whole. This is true for both those employers who have a safe haven under section 530 and those who do not.

Table 2. Employee/Independent Contractor Misclassification

Item	(1) Reclassified Independent Contractor to Employee	(2) Protected by Section 530	(3) Total (1) + (2)
Number of employers	692,488	70,220	755,458*
Number of employees	3,084,742	307,014	3,391,756
Compensation (millions)	$13,848	$2,163	$16,011
FICA Assessed (millions)	$988	$156	$1,144
FUTA Assessed (millions)	$183	$21	$204
Income Tax Withholding (millions)	$1,042	$132	$1,174

*7,250 employers were found to have both employees who could be reclassified and those with section 530 protection. This can occur where section 530 requirements have only been met for a particular category or workers. These 7,250 employers appear in both columns 1 and 2; thus, the employer total in column 3 is less than the sum of that in columns 1 and 2.

Table 3 reports the primary Safe Haven provision that applies to Section 530 employers. Industry practice and prior exam are shown to account for almost all protection. It is estimated that 35,042 employers are exempt from reclassification because of long-standing industry practice. The survey indicates that 33,179 employers were exempt from reclassification because of a prior Service examination. Only 237 employers were estimated to qualify under Section 530 due to a judicial precedent and only 1761 employers were estimated to qualify under Section 530 due to other reasons.

Table 3. Section 530 Primary Safe Haven Provision

Judicial Precedent	237
Prior Examination	33,179
Industry Practice	35,043
Other	1,761
Total	70,220

Conclusions

This report has focused on employment tax and misclassification portions of the SVC-1 employer survey. Although voluntary reporting levels for Form 940 and Form 941 are found to be in excess of 96 percent, the amount of underwithholding and nonpayment of FUTA and FICA is found to be $3.5 billion in tax year 1984. This consists of $1.6 billion in income taxes not withheld, a $196 million loss in FUTA taxes and a $1.7 billion social security tax loss. Noncompliance with employment taxes is resulting in a substantial loss in federal revenues. There is no reason to believe that this loss has declined since that time.

Misclassification of employees is estimated to affect 3 million workers and $16 billion in compensation. Section 530 provides protection for 9 percent of these workers and 14 percent of their compensation. Thus, Section 530 is shown to provide protection for a small, but significant share of employers who misclassify their workers. The estimates presented here are conservative. They represent employers with employment tax filing requirements but do not include withholding and employment tax noncompliance for employers who are completely noncompliant with employment taxes regulations.

Notes

1. Service firms include those with principal industrial activity (PIA) codes of 7000 - 8999. This includes lodging, laundry, photographic, personal care, funeral, advertising, computer, data processing, management consulting, public relations, equipment rental and leasing, automotive rental and leasing, automobile parking, automobile repair, radio and TV repair, electrical repair, reupholstery and furniture repair, motion picture and video tape production and distribution, motion picture theaters, amusement and recreation, medical and dental, legal, educational, accounting and ministerial services.

Withholding Noncompliance Study (SVC-1)
Employer Checksheet

(See Manual Supplement for Instructions)

For Data Center Use

Attach the AIMS File Label of 940 return or print

1 Name

EIN

Address

2 PIA Code

3 Business Form of Employer

(1) ☐ Corporation
(2) ☐ Sub-S Corp
(3) ☐ Partnership
(4) ☐ Sole Prop

(5) ☐ Exempt C
(6) ☐ Fiduciary
(7) ☐ Governm
(8) ☐ Other

Employment Tax Return Information (Dollar Amounts Only No Commas)		Per Return (1)	Per Exam (2)
4 Form 940 Total Payments (Part I Line 1)	4		
5 Form 940 Taxable Wages (Part I Line 5)	5		
6 Form 940 FUTA Tax (Part II Line 3) or (Part III Line 6)	6		
7 Form 940 Total Penalties	7		
8 Forms 941 Total Wages (Line 2)	8		
9 Forms 941 Total Income Tax Withheld (Line 3a)	9		
10 Forms 941 Taxable Social Security Wages Paid (Line 6)	10		
11 Forms 941 Total Penalties	11		
12 Verification Total (Total lines 4 thru 11)	12		

W-2/W-4 Information

13 Enter the number of 1984 Form(s) W-2 filed by the employer	13	
14 Enter the number of W-4's submitted to the employer during 1984 claiming more than 14 withholding allowances	14	
15 Enter the number of W-4's in item 14 which were transmitted to the Service	15	
16 For the W-4's transmitted in item 15, enter the number of occasions where the Service contacted the employer to change the employee's withholding allowances	16	
7 Enter the number of occasions in item 16 where the employer complied fully	17	
8 Enter the number of employees who left employment prior to Service notification in item 16 indicating a change in their withholding	18	
9 Enter the total number of W-4's submitted to the employer during 1984 claiming "exempt" which were required to be submitted to the Service	19	
0 Enter the number of W-4's in item 19 which were transmitted to the Service	20	
1 For the W-4's transmitted in item 20, enter the number of occasions where the Service contacted the employer to change the employee's withholding status	21	
2 Enter the number of occasions in item 21 where the employer complied fully	22	
3 Enter the number of employees who left employment prior to Service notification in item 21 indicating a change in their withholding	23	
4 Enter the number of employees claiming "exempt" who failed to file a required W-4 for 1984	24	
5 Verification Total (Total lines 13 thru 24)	25	

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Employee/Independent Contractor Information

6 Were any independent contractors **ACTUALLY** changed to employees?
(If item 26 is "YES" complete items 27 and 28) (1) ☐ YES (2) ☐ NO

7 Complete the following aggregate information for those independent contractors who were **actually** reclassified as employees. Use whole dollar amount only in the money entries.

a Total number of workers reclassified	a	
b Total amount of compensation reclassified as wages	b	
c Total FICA tax assessed on the compensation shown on line b	c	
d Total FUTA tax assessed on the compensation shown on line b	d	
e Total income tax withholding assessed on the compensation shown on line b	e	
f Verification Total [Total Lines 27(a) thru 27(e)]	f	

8 Complete the following information for each independent contractor who was actually reclassified as an employee. **ALSO, COMPLETE SECTION A OF THE MISCLASSIFIED EMPLOYEE CHECKSHEET(S) FOR EACH INDIVIDUAL LISTED.**

	Last Name, First, MI (1)	SSN (2)	Amount of Compensation Reclassified as Wages (Dollar amounts, no commas) (3)
(a)			
(b)			
(c)			
(d)			
(e)			
(f)			
(g)			
(h)			
(i)	**VERIFICATION TOTAL** [Total items (a) thru (h)]		

(If more than 8, list the remaining names and information on a separate page.)

28 Would any independent contractors have been reclassified as employees except for Section 530 Safe Harbor provisions?
(If item 28 is "YES", complete items 30 through 32) (1) ☐ YES (2) ☐

30 Enter the code for the primary Safe Haven provision which applies
(1) Judicial Precedent
(2) Prior Examination
(3) Industry Practice
(4) Other (Explain in Remarks) 30 ☐

31 Complete the following aggregate information for those independent contractors who were employees but were **NOT** reclassified due to Section 530 S harbor provisions. Use whole dollar amounts only in the money entries

a Total number of workers who would have been changed but were not .... a

b Total amount of compensation that would have been reclassified as wages but was not .... b

c Total FICA tax that would have been assessed on the compensation shown on line b c

d Total FUTA tax that would have been assessed on the compensation shown on line b .... d

e Total Income Tax Withholding that would have been assessed on the compensation shown on line b .... e

f Verification Total [Total lines 31(a) thru 31(e)] .... f

32 Complete the following information for each independent contractor who was an employee but **NOT** reclassified due to Section 530 Safe harbor provisions. **ALSO, COMPLETE SECTION A OF THE MISCLASSIFIED EMPLOYEE CHECKSHEET(S) FOR EACH INDIVIDUAL LISTED.**

	Last Name, First, MI (1)	**SSN** (2)	**Amount of Compensation that would have been reclassified as wages** (Dollar amounts, no commas) (3)
(a)			
(b)			
(c)			
(d)			
(e)			
(f)			
(g)			
(h)			
(i)	**VERIFICATION TOTAL** [Total items (a) thru (h)]		

(If more than 8, list the remaining names and information on a separate page.)

Section 911 Information

33 Were any employees claiming exemption from withholding under Section 911?
(If item 33 is "YES" complete item 34) (1) ☐ YES (2)

34 Complete the following information for each employee
(A MISCLASSIFIED EMPLOYEE CHECKSHEET WILL NOT BE COMPLETED FOR THESE INDIVIDUALS.

Last Name, First, MI Address (1)	SSN (2)	Gross Wages Paid (Dollar Amounts, no Commas) (3)	Required Statement Submitted to Employer?	
			YES (4)	NO (5)
(a)				
(b)				
(c)				
(d)				
(e)				
(f)				
(g)				
(h)				
(i) VERIFICATION TOTAL (Total items (a) thru (h))				

(If more than 8, list the remaining names and information on a separate page.)

Control Data

35 Examiner's name	36 Date	37 Completed By (1) R/A ☐ (2) R/O ☐	38 Time on Case	39 GS Grade
40 Group Manager's Name	41 Date	42 D.O. Code	43 Resolution Code (1) No Change ☐ (2) Agreed ☐ (3) Unagreed, No Appeal Requested ☐ (4) Unagreed, Appeal Requested ☐ (5) Estimate ☐ (6) Other ☐	
44 Remarks				

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28. **The IRS Collection function is using information returns to identify employees misclassified as independent contractors. Why is Collection doing the examinations?**

Collection has a vested interest in correcting the misclassification problem. Misclassified workers present far reaching tax administration consequences particularly in the area of personal income tax compliance. Studies have shown that workers incorrectly classified as independent contractors by their employers are less likely to file a personal income tax return than legitimate independent contractors. The increase in delinquent filings creates an additional burden on the collection system. Conversely, correct classification and reporting at the source prevents a mushrooming of compliance problems.

The Collection Employment Tax Examination Program, which is an adjunct to Examination's program, began in 1986 after a successful study and test. GAO concurred in the recommendation that Collection conduct examinations after reviewing the prospectus and prototype. GAO also requested assistance from Collection to conduct a study to determine the feasibility of using information returns to identify employees who are misclassified. As a result of that study GAO recommended to Collection that information returns be used as a source of leads for the employment tax program.

29. **Some have said that because the IRS audits only selected companies within an industry, the IRS is creating dichotomies in which businesses must count workers as employees while their unaudited competitors can treat similar workers as independent contractors. Can a test be developed which will provide a solution to this problem? Are similarly situated taxpayers being treated differently?**

The problem has its roots in the law and its interpretation. The law also limits the Service from providing nationwide technical guidance in the form of a revenue ruling. If Section 530 of the Internal Revenue Code did not exist or, if it were adequately modified, a revenue ruling could possibly be issued to provide uniform standards within an industry. Expanded Examination coverage could mitigate but not eliminate the dichotomies cited.

Because of the safe harbors in Section 530, it is possible that two taxpayers in similar circumstances in a geographic area would each handle the employee/independent contractor issue differently. Additionally, if industry practices vary from region to region, similar taxpayers in different regions could be treating workers differently.

The Service is currently studying this area in terms of legislative changes and/or administrative remedies that need to revised to better address the issues involving employees and independent contractors.

30. **What programs does the IRS have to address noncompliance by sole proprietors? What programs does the IRS have on the drawing board?**

Our Examination function plans to increase audit coverage of sole proprietors from 1.76% in FY 90 to 2.01% in FY 91. Currently, they have a national program to address noncompliance by direct sellers. The program identifies returns which are forwarded to districts for examination. Our compliance teams (C Teams), which are located at the service centers, also review Schedule C returns to identify new, emerging areas of noncompliance.

Collection's Employment Tax Examination program addresses employment tax compliance by some sole proprietors. In addition, some non-filers (those who have self-employment or partnership income of no more than 30 percent of their total positive income) are now processed through the Collection Substitute for Return program rather than through the Examination program. There are also many local returns compliance programs such as the one currently under way in Southeast Region on certain contractors. A program is also being considered to address employment tax compliance by employers, including sole proprietors, based on complaints from taxpayers that the employer failed to furnish them Forms W-2.

31. **The tax gap figures used in the GAO report do not take into consideration noncompliance by nonfilers. Recently, there has been a phenomenal growth in the number of extensions filed by taxpayers. The Commissioner's Advisory Group expressed concern in June 1989 that the IRS does not follow up when a taxpayer files for an extension but does later file a return. To what extent is nonfiling a problem? How much do nonfilers contribute to the tax gap?**

In our most recent reports, we estimated that nonfilers contributed $7.2 billion to the Tax Year 1987 legal-sector income tax gap; under 10 percent of the total.

The IRS does a specific follow up on taxpayers with expired extensions if the account shows a credit balance. Those cases where no credit balance appears are treated as general taxpayer delinquencies and are added to the regular non-filer inventory. However, we plan to follow up on all taxpayers with expired extensions beginning with tax year 1989. Collection deals with nonfilers by sending delinquency notices, making telephone calls and field visits, and by using substitute for return procedures.

The substitute for return program involves determining a tax liability for a non-filer based on reported income. Once determined, the liability is assessed under Internal Revenue Code Section 6020(b), using deficiency assessment procedures. Taxpayers who voluntarily disclose non-filing should continue to be charged applicable penalties (absent reasonable cause) and interest. All delinquent returns voluntarily filed should continue to be screened for conditions which may warrant examination or criminal investigation.

32. **The GAO reports that the IRS has been concerned about unreported income among fishermen. The IRS estimates the related annual tax loss to be about $125 million. The IRS also has found cases where wage-earners, such as in the building trades, nurses, and seasonal workers, work on the side either to generate income that is easy to hide or to create business losses that can be used to lower the tax liability of their wages. How successful is the IRS in detecting this kind of noncompliance? Should the IRS coordinate with state and local governments to require proof of Federal tax filing before granting authorization to do business? Are there external information sources which would be helpful in curbing noncompliance? To what extent would expanding information reporting enhance compliance?**

Unreported income by wage-earners who "moonlight" at a second job and are paid in cash is extremely difficult to detect. Examiners are taught several auditing techniques to use during examinations to identify such income, such as indirect method of verifying income. Our district offices do coordinate with state and local governments to obtain external information which is often used to establish local projects to detect such noncompliance. We continue at both the national and district office level to explore additional areas with the states to improve our ability to detect noncompliance. In addition, we plan to devote efforts to improving payer compliance with filing information documents. To the extent the payments require the filing of a Form 1099-MISC, increased and improved payer compliance will enhance our ability to detect this income through our matching program.

Currently, a taxpayer does not have a specific document to present to offer proof of filing Federal tax returns. Perhaps, more important, proof of filing Federal returns would not identify wage-earners who "moonlight" at a second job as they file returns but fail to report all income or reduce taxable income by losses.

33. **How easy is it for this type of under-reporting of income to go undetected and why? Do various schemes seem to be more local in scope? Do IRS districts tailor compliance projects to address local under-reporting income schemes?**

Whenever a taxpayer receives income in the form of cash, it is more difficult to detect because there is usually no audit trail or records to identify the cash received. Without records or a trail, it is difficult to follow up with third parties to substantiate amounts received.

IRS districts initiate information gathering projects which are local in scope to determine the level of non-compliance in local industries such as the fishermen, loggers, and casino tip income projects.

34. **The Oversight Subcommittee has learned that IRS district offices employ local strategies to deal with this type of noncompliance. These local compliance initiatives are not however, coordinated at the national level. Therefore, successful compliance efforts are employed throughout the country on an ad hoc basis. Why doesn't the IRS coordinate these local compliance efforts?**

Some Examination compliance efforts are coordinated at the national level such as the "Direct Sellers" Program. National coordination is undertaken when we determine that the compliance problem exists nationwide. Other compliance efforts are initiated at the district level to address compliance problems in a specific geographic area. There are instances where a project initially began at a local level, but, because the problem had nation-wide impact, was later coordinated at the national level. To facilitate in identifying whether a project is localized or nationwide, the National Office shares a listing of all open Information Gathering Projects with regions and districts.

In addition, Collection conducts local Returns Compliance Programs. The local returns compliance programs are designed to deal with compliance problems unique to a local area due to special economic circumstances. For example, we have compliance programs to deal with fishermen in some areas of the country where non-compliance by members of that industry is a problem and with drywall mechanics and installation firms in other sections of the country where new construction is prevalent. Our procedures require that local projects be approved by the National Office for programs which replace national programs, and at the regional level for all other programs. Further, regions are required to notify the National Office of regionally-approved programs, and to report to National Office the results of all local programs. National Office uses these reports to determine if local programs should be expanded nationwide.

35. **The IRS reports that only $700 million was lost in 1987 as the result of informal suppliers not filing income tax returns. How did the IRS arrive at this figure, particularly if taxpayers didn't file returns? Who are these taxpayers that don't file returns? To what extent are nonresident aliens part of this problem?**

Our estimate of the TY 1987 tax gap related to informal suppliers is $8.4 billion; $7.7 billion among filers and $700 million among non-filers. These estimates are based on IRS-sponsored research on informal supplier income conducted by the Survey Research Center of the University of Michigan, an analysis of IRS's Taxpayer Compliance Measurement Program data, and an interagency database. The latter database was able to distinguish between filers and nonfilers.

Informal suppliers are entrepreneurs in the legal sector of the economy who operate in an informal style (such as in cash), making it possible for them to evade income taxes. Informal suppliers who file income tax returns may be working in their trade (such as an electrician or plumber) in a "moonlighting" arrangement, keeping the extra income "off the books." Those who do not file returns may devote their full time to the informal business (such as a sidewalk vendor). Many of those who do not file returns do not actually have an income tax liability because they have incomes below the filing threshold.

We do not have any information concerning the extent to which nonresident aliens are a part of this problem.

36. In 1988, the IRS Coordinated Examination Program's (CEP) national caseload included only 276 corporations that were ranked among the top 500 corporations in assets. Most of the other 224 corporations not included in CEP came from banking and finance industries. In 1988, the IRS completed examinations of 307 of the 1,461 corporations in CEP. Two thirds of the 307 corporations accounted for $6.5 billion of the $8.9 billion in recommended taxes. Twenty-one petroleum and banking cases accounted for $2.5 billion. Exactly why were large corporations in the petroleum and banking industries responsible for the highest noncompliance? Why are so many banking institutions excluded from the CEP program? How many banks or financial institutions does the IRS audit each year?

The Coordinated Examination Program (CEP) covers taxpayers where their examinations warrant a team audit. There are a number of factors which influence whether a team audit is the most effective and efficient way to conduct the examination. These include: gross assets; gross receipts; operating entities; multiple industry status; the number of team members and specialists needed for the audit; the number of support districts necessary for the audit; and the staff days necessary for the examination. In effect, we are looking at the complexity of the audit and the need for a team approach which differentiates CEP taxpayers from General Program cases.

While the CEP criteria provided for inclusion of 156 banks or financial institutions, there are substantial examinations of banks in the general audit program. A recent survey by our Industry Specialization Program disclosed that there are 366 savings and loan institutions and 677 commercial banks under examination.

The issues raised in the examination of large corporations in the petroleum and banking industries are substantial; however, it is relative to the gross income reported by them. Generally, the larger the corporation is with respect to assets, sales, foreign operations and operating entities, the larger the adjustments. Because the issues in these industries are unique, the Service has established Industry Specialization Programs in both industries. The proposed recommended tax adjustments tend to be in line with the income that they report.

37. It is admitted that about 70% of the recommended tax deficiencies proposed by Examination with regard to corporations are ultimately conceded by the IRS during the administrative process. Do IRS auditors make erroneous determinations or do Appeals officers bargain away legitimate issues? Are corporations abusing the Appeals process?

Examination and Appeals have two separate missions. The mission of Examination is to determine that the proper tax is paid. In fulling this mission, the issues raised by examiners can be very complex and may fall within one of the many gray areas of the tax law. The mission of Appeals is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer.

Revenue agent raise tax issues based on factual determinations and application of the Internal Revenue Code, regulations, procedures, and case law. The appropriateness of the issues raised and the conclusions made by the examiner are reviewed by the examiner's group manager. The case may be reviewed by a separate function within Examination known as Quality Review. In addition, cases may be sent back to Examination for further development by Appeals where facts have not been considered or fully developed by the Revenue Agent.

Appeals, by the nature of their function, has been delegated a high degree of authority to resolve and settle issues which our examiners do not have. To a large extent, this settlement authority provides them the ability to resolve tax controversies using hazards of litigation as one criteria for resolving issues. While the 70% figure for deficiencies conceded by Appeals is in line with our estimates, this figure does not necessarily represent the disposition of all issues or case deficiencies proposed by Examination.

On an issue by issue basis, Appeals estimates that it sustains between 40% and 50% of the adjustments proposed by Examination and placed in dispute by taxpayers. The amount of tax actually owed by a taxpayer will be affected by items such as tax credits and loss carrybacks originating in tax years subsequent to those in which adjustments take place, as well as new issues raised by taxpayers which offset adjustments proposed by Examination. These items tend to reduce the tax owed disproportionately to the amount of audit adjustments sustained in Appeals. If undisputed adjustments to tax computations were taken into account prior to determining Appeals' results, the "recovery rate" could be significantly higher.

The sustention and recovery rates are also affected by legal developments taking place after the examination is completed. For example, Examination may propose adjustments which represent the Service's litigating position on an issue. If that issue is later settled or conceded in Appeals because litigation taking place after the examination is adverse to the government's position, the sustention and recovery rates are reduced. In both these cases, Examination and Appeals acted correctly.

The Service does not maintain data as to what portion of Examination adjustments are attributable to purely erroneous determinations by Examination, although we believe that determinations based on misunderstanding or misapplication of law to facts known by Examination are insubstantial.

We do not believe that Appeals bargains away legitimate issues. The feedback from quality review process for Appeals' large cases does not indicate that this is taking place. In fact, our discussions with practitioners also belie this. Some practitioner groups believe that our Appeals officers are too unwilling to bargain on any case.

We have observed recently a growing number of large corporations who are cutting off the examination process by refusing to consent to extensions of the period of limitations and forcing the issuance of a notice of deficiency. This may force Examination to formulate its adjustments from an incomplete audit. In order to protect the legitimate interests of the government, adjustments are proposed which might not have been had the audit been fully completed. The taxpayer generally submits the information needed to complete the audit during the litigation process (either while Appeals has the case for pre-trial settlement or during the course of trial preparation) and many of the examination adjustments will be consequently be eliminated or substantially reduced. Exceedingly large proposed deficiencies and seemingly small sustention/recovery rates will result from this taxpayer strategy for reducing the time frame for the examination.

Whether the use of this strategy is an abuse or simply good strategy by taxpayers is, largely, a value judgement. If the use of this strategy continues to grow, we would see it as a problem that needs to be addressed, because examinations cannot be routinely conducted effectively under the rules that prevail when a taxpayer is in a docketed status. The appeals and litigation processes are not set up to handle the demands of substantially incomplete examinations, especially of large and complex organizations.

33. **The GAO indicates that large corporations with professional tax counsels have "aggressively used vagueness in the tax law" to reduce their tax liability. For instance, the GAO says corporations have claimed questionable research tax credits, taken duplicate deductions, and expensed instead of capitalized and depreciated assets. The IRS has had to contend with some issues year-after-year as companies repeat practices that have been previously raised in examinations. What can be done to curb these abuses? Are there sufficient sanctions to deal with this kind of corporate behavior? Do corporations continue to take aggressive positions knowing the IRS is incapable of handling sophisticated tax issues or will settle for less than what is actually due and owing?**

Corporate law is very complex which provides opportunities to interpret positions in ways that produce different tax results. There are many gray areas in which the final disposition of an issue is not clear. Added to this is a recognition that business operations and, thus tax transactions are also becoming more complex as evidenced by globalization. Consequently, tax planning can reduce the overall tax liability of a taxpayer. In addition, recurring issues from year-to-year are not necessarily the result of abuse or questionable positions taken by the taxpayer. Facts and circumstances often change from year to year.

We have just concluded a study of the Coordinated Examination Program which is responsible for the examination of the largest corporations. We concluded that a number of changes are needed in this Program to improve our examination of large corporations, as well as our ability to better identify noncompliance in the changing environment of the business community. Some of the changes which will be implemented include increased industry specialization, involvement of Counsel in the development of issues, establishment of technical Examination experts for a limited number of complex areas, and, bringing top management into the planning process.

In abusive situations, the Service has an array of penalties, including Section 6661, Substantial Understatement of Liability and Section 6653, Additions to Tax for Negligence and Fraud. In addition, in an attempt to secure documentation from the taxpayer, there is summons enforcement as well as Section 982 dealing with the admissibility of records maintained in a foreign country.

39. **Two years ago, the Oversight Subcommittee asked the IRS to identify noncompliant corporations and the issues in dispute. We asked what these corporations are doing that contributes to the tax Gap (e.g. not filing returns, overstating deductions, not reporting income). The IRS maintained that this information was not available. Can the IRS answer these questions today?**

The Service tracks the results of large corporate (Coordinated Examination Program) taxpayers capturing the additional tax proposed on the examinations, but not by issue.

On an industry basis, our Industry Specialists in Examination are concerned with issues on identified key cases (significant cases) and do follow these issues through to their final disposition in order to establish a Service position.

The study of our Coordinated Examination Program recommends that significant issues be tracked on a limited basis. This recommendation has been approved for implementation. While this will provide information on significant issues in the Coordinated Examination Program, the system will not provide information on corporate examinations in the general examination program.

40. **With regard to corporations with assets over $250 million, examination coverage decreased from 782 in 1986 to 642 in 1988. Despite the decrease the IRS recommended almost $1 billion more in taxes and penalties. If the examination program is the most effective way to pursue corporate noncompliance, why were audits cut?**

From FY 1986 to FY 1989, the staffing being devoted to the examination of corporate returns with assets over $250 million has remained constant. A large percentage of that staffing was applied to Coordinated Examination Program (CEP) returns and less to non-CEP returns. Since CEP cases take significantly longer to examine and produce more yield than non-CEP cases in this class, the number of examinations has decreased while the yield has increased.

For FY 1990, we shifted staffing into non-CEP cases in this class from lower yielding areas without impacting CEP. During the period FY 1987 - 1989 we were unable to accomplish this due to a significant staffing investment in training the FY 1987 and FY 1988 revenue agent hires. We expect coverage to increase in this area in the future.

41. **The Oversight Subcommittee understands that the IRS is studying ways to better recover assessments from examinations that are appealed or litigated. In 1988 Tax Court cases, the IRS recovered 38% of the $1.1 billion in disputed taxes but only 30% of the $513 million disputed by those with assets over $50 million. What do the IRS's preliminary findings reveal? How successful is the IRS in court? Are IRS attorneys "outmanned and outgunned"? What do these court figures tell us about corporate behavior and IRS behavior?**

A notable recent trend is the growth in large dollar (nonshelter) cases in the Tax Court. The number of docketed cases over $10 million has increased by 23% from FY 1987 to FY 1989 and the total dollars at issue in large dollar (nonshelter) cases over $10 million have increased $1.9 billion, a sizable 20%, over the same time period. The issues in these cases typically are more sophisticated and difficult to resolve, and often have industry-wide impact.

We are focusing more of our resources on this growing inventory of complex, large dollar cases. For example, the Industry Specialization Program was instituted to structure examinations within specific industries to raise issues which are common to most members of that industry. The program utilizes the team approach to provide legal and technical support to each industry group in areas such as the examination planning process, early identification and resolution of audit problems, tax litigation advice requests, case and issue coordination, and designation of issues for litigation. In addition, we are in the process of implementing structural changes to our Large Case Program to provide better coordination, development and management of issues in large cases, including litigation teams for the largest cases.

With respect to recovery rates, the figures cited are generally consistent with IRS data. However, especially for large, complex cases, the "recovery" rate [i.e. the amount determined by the final entered decision in the case, divided by the amount set forth in the statutory notice of deficiency] is an extremely unreliable indicator of the quality and efficiency of the Service's enforcement program. The final amount entered in a large case decision frequently includes offsets for allowable carrybacks and other adjustments which were never adjusted or at issue in the statutory notice of deficiency. Also, large dollar cases frequently involve difficult, precedential issues for which litigation is necessary in order to obtain judicial guidance and clarification of the law, even though there may be substantial litigation hazards. Focusing only on the monetary amounts "recovered" in cases tends to ignore the important benefit to tax administration derived from the litigation process.

42. **Some have recommended that IRS take additional steps to protect taxes owed by corporations that are going through bankruptcy because they do not pay what they owe. How serious is this problem? What needs to be done?**

The problem identified is the pyramiding of employment taxes during the pendency of a reorganization. This applies primarily to corporations but also includes a small percentage of noncorporate proprietors. According to the latest statistics from the Office of Assistant Commissioner (Collection), at the present time the outstanding balance of post-petition employment taxes that debtors in reorganizations have incurred but failed to pay is somewhere in the neighborhood of $112 million. Given the high failure rate of chapter 11 plans, it is probable that a large portion of this outstanding amount will never be collected.

A legislative solution to this problem would be an amendment to the Bankruptcy Code which would require a debtor in a reorganization to keep current on taxes under penalty of automatic dismissal or conversion. An alternative would be an amendment to the Bankruptcy Code which would spell out in specific language that a ground for dismissal or conversion is the failure to keep current with all tax liabilities.

43. **Some have recommended that the IRS take quicker action to collect taxes withheld from employees before the debt becomes unmanageable for the corporation. What is the IRS doing to improve controls over those who improperly use tax money they owe to bolster a failing business?**

Currently, the Service monitors the paying status of certain selected employers based on the amount and frequency of Federal Tax Deposits (FTD's). The program, called the FTD Alert program, generates a contact with an employer, prior to the due date of a quarterly employment tax return, when our records indicate that there may be a substantial underpayment of tax involved. During the second calendar quarter of 1990, 14,506 FTD Alerts were issued.

The Service is also examining methods to shorten time frames that it takes for Trust Fund cases to be worked. If Service personnel can reach a business before the tax debt burden becomes to great, then perhaps a financial plan can be worked out letting the business continue to operate while, fulfilling the delinquent tax obligations. Conversely it may be necessary to close a business before pyramiding of trust fund taxes begins. Generally, a business is closed when a taxpayer has the financial ability to satisfy a delinquent tax liability but fails to do so or the financial circumstances of the business are such that the delinquent liabilities cannot be satisfied and the business will continue to accrue liabilities in the future.

44. On November 15, 1989, the Oversight Subcommittee requested information of the IRS's "Compliance 2000," strategic initiative which was created in April 1988. Compliance 2000 is a planning strategy aimed at both revenue enhancement and closing the tax gap through enforcement and assistance programs. The Subcommittee asked very specific questions about the project and the compliance issues being discussed. On December 28, 1989, the IRS provided preliminary information on the project and indicated that the Compliance 2000 final report would be available by the end of March. On March 29, 1990, the IRS sent a follow-up letter providing a broad overview of the Compliance 2000 project.

The Oversight Subcommittee has been trying to get information on this project for several months with little success. Why has the IRS failed to respond to our specific questions? Where is the final report? When will it be ready? Why is it taking so long to complete a project that was initiated more than two years ago? What problems has the project encountered in formulating a strategic plan for leading the IRS compliance activities into the future? What changes have been made to the report?

While the Compliance 2000 preliminary data collection has been completed and a report is being circulated among IRS senior executives, we are unprepared to release that report at this time.

This strategic initiative has taken longer than we first anticipated, yet, the efforts of the task force are of significant value to concepts being developed for use in our long range planning. The number of internal and external sources from which the task force had to draw information was quite extensive.

Once we have had an opportunity to fully discuss and approve this report, we will be happy to brief the subcommittee and staff on the concepts and the new directions we intend to take as we move through this decade and into the next century.

45. **The honest taxpayers are bearing an ever-increasing burden because of the growing number of citizens who are not paying their full tax. As the honest taxpayer's burden increases, the growing inequity of the situation may convince them that they are paying an unfair share. This in turn, could motivate some of them to join that segment of society that is not paying what the law requires, and might ultimately lead to the breakdown of the voluntary compliance system itself. What factors or framework of issues should the Oversight Subcommittee consider in seeking ways to improve taxpayer compliance? Where can the most progress be made? Should these compliance issues be addressed through legislation, increased enforcement, and/or increased taxpayer education and assistance?**

Improvements in taxpayer compliance will only result from a multi-faceted approach that includes all of those areas. To a great extent, compliance hinges on the belief that the tax system is fair, equitable and relatively easy to comply with. Tax law complexity makes it difficult for some taxpayers to comply. As noted earlier, further simplification is needed.

We also need to continue the steady, modest growth in IRS enforcement resources. The President's proposed FY 1991 budget would allow us to undertake some important enforcement initiatives. Continued steady growth would allow us to plan and apply those resources more effectively Systems enhancement and improvements, as described elsewhere, will also aide us in developing a better understanding of non-compliance.

Continued expansion of taxpayer education is also necessary to improve voluntary compliance. We will continue to expand our programs dealing with small businesses and practitioners. Practitioners now assist about one-half of all taxpayers. To further extend the reach of our education efforts, we are working to enhance our volunteer assistance programs. In the past ten years, over 80,000 volunteers have provided tax assistance or education to 3.3 million taxpayers.

46. **To what extent should the following recommendations be considered:**

Identify and promote changes to the tax law that promote simplification and fairness?

A key component to enhancing voluntary compliance is fairness and simplification. Towards this goal the IRS is continuing to work closely with the Assistant Secretary of the Treasury (Tax Policy) in recommending to the Chairman of the House Ways and Means Committee and others on the Ways and Means Committee possible areas of the Tax Code that require further simplification.

Establish new techniques to detect unreported income?

The Service is constantly looking for new or better techniques for detecting unreported income, such as increased information reporting. We also need to improve our systems to more effectively use information that is already submitted.

Take steps to insure U.S. tax law compliance by nonresident aliens?

Nonresident aliens are generally subject to similar filing and taxation rules as other taxpayers. We have examination programs for nonresident income tax returns and foreign corporations. Additionally, nonresidents are subject to withholding from U.S. source wages and from dividends. Income from the sale of real estate may be subject to withholding under FIRPTA. Other sources of income, most notably interest and capital gains from sales of stock and other capital assets (other than real estate) are not taxable. Overall, we believe current laws are effective in promoting compliance by nonresident aliens.

Streamline the process for collecting 100-percent penalties?

Under IRC Section 6672, Failure to Collect and Pay Over Tax or Attempt to Evade or Defeat Tax, we may assert the penalty against the person(s) who willfully failed to carry out his/her responsibility to pay over withheld taxes. The most time consuming part of the process is the investigation necessary to determine exactly who had the responsibility.

Once we determine who is liable, we notify the person(s) and advise him/her of the right to protest our determination to the Appeals function. Currently, interest on a 100-percent penalty begins to accrue only after the 100-percent penalty is actually assessed. Therefore, it may be in the responsible person's best interest to delay the assessment of the penalty as long as possible. We have received reports that taxpayers and their representatives are employing such delaying tactics. This could be corrected if IRC 6601 was amended to require that interest accrue from the due date of the underlying tax return.

Explore ways to better use state tax information?

The IRS will continue to work with state governments, individually and through the Federation of Tax Administrators, to enhance cooperation between federal and state taxing authorities.

Expand enforcement with special emphasis on special compliance activities?

It is essential that we continue all of our efforts aimed at detecting non-compliance so we can design approaches to correcting the problems and preventing additional non-compliance.

Improve the effectiveness, efficiency and accuracy of automated compliance systems?

We are using automated systems in our enforcement functions to improve the speed and accuracy of our efforts. We will continue to explore better ways to perform our enforcement mission.

Improve the accuracy of the telephone assistance service?

We must continue our efforts to improve the accuracy of our telephone assistance program. This would improve taxpayer confidence in the system, which is an essential ingredient to promoting voluntary compliance.

Improve efforts to identify compliance in the nonfiler population and develop ways to identify nonfilers not covered by information reporting?

We will continue to explore ways to deal with nonfilers. We have extended the reach of our Substitute for Return program to cover taxpayers whose self-employment income is less than 30% of gross income reported from all sources. We also should continue our efforts to make full use of information returns and information from other sources to identify those taxpayers who are not filing.

Pursue criminal noncompliance in the legal sector through the Criminal Investigations Division General Enforcement Program?

We cannot overstate the importance of the General Enforcement Program. As the sophistication of financial crimes increases, we must continue our efforts to meet these schemes and promote voluntary compliance.

Improve automated systems to identify returns with high audit potential?

This is one area where we are using automation to improve the efficiency of our compliance resources. Under development is a new Automated Issue Identification System which will use artificial intelligence to select returns for examination.

Educate taxpayers to assist them in complying?

Currently, IRS devotes significant resources to educating and assisting taxpayers in their efforts to comply with the law. We are committed to improving both the quality and the scope of the services that we provide to taxpayers.

47. **The GAO report attached (on page 105) provides a number of legislative proposals submitted by the IRS to Treasury and forwarded to Congress. Of the proposals for legislative change listed, which ones would be most constructive in terms of enhancing compliance?**

The following legislative changes would enhance compliance: (As numbered in the GAO report)

5. Require fiduciaries to report certain information on beneficiaries on Form 1041, in addition to filing information returns..

6. Penalize Subchapter S corporations, in much the same way as Section 6689 penalizes partnerships, for failure to file tax returns or information returns on its shareholders.

8. Allow completion of the tax assessment process for taxes determined to be owed by businesses filing for bankruptcy, if the determination preceded the petition.

14. Require withholding on payments to certain fishing boat crew members.

15. Require expanded information reporting on foreign-owned corporations to include information on inter-company transactions within a controlled group.

Question Raised in Chairman Pickle's August 16, 1990 Letter

Please provide a list of problem areas in the Federal tax system which the IRS has identified as contributing significantly to the tax gap. Please also provide a list of recommendations for narrowing this gap, including comments on what steps could be taken to address the growing accounts receivable inventory.

The Commissioner's testimony at the hearing on April 19, 1990 provided detailed background on various components of the tax gap and solutions. In summary, the Commissioner cited complexity of the tax laws, lack of adequate enforcement, and, outdated computer systems as contributing to the tax gap. To close the gap, a balanced, long-term strategy of assistance, education and enforcement is necessary. This strategy includes modernizing our computer systems; expanding and enhancing the quality of our taxpayer service and education programs; expanding and enhancing the quality of our enforcement efforts; and, simplifying our laws, regulations and administrative procedures. A complete copy of the Commissioner's statement is attached.

With regard to accounts receivable, the Commissioner noted in his testimony at the February 20 hearing that the current inventory level was the result of a combination of factors. He further noted the wide range of actions the Service was taking to address accounts receivable.

In terms of Congressional assistance with accounts receivable, two areas stand out: support for the FY 1991 budget for the IRS and consideration of the kinds of legislative proposals forwarded to you with Deputy Commissioner Brennan's April 17 letter. Copies of those proposals are enclosed. We are also working on others that are intended to simplify tax rules or to specifically target areas of noncompliance. To the extent we can get taxpayers to report and pay their correct liabilities initially, the growth in the government's accounts receivable inventory will be limited. In addition, the work we are doing to ensure proper reporting of payments to employees and to independent contractors will substantially improve compliance and reduce accounts receivable over the long term.

AMENDMENT TO BANKRUPTCY CODE TO PERMIT ASSESSMENT OF CERTAIN TAXES

Proposal

Amend Section 362, the automatic stay provision of the Bankruptcy Code (11 U.S.C.§ 362), to permit the IRS to "assess" a tax liability and send out the first notice of amount due.

Reason for Change

Section 362(a)(6) of Title 11 of the U.S. Code provides for an automatic stay prohibiting the IRS from assessing a tax liability owed by the debtor. This prohibition causes the IRS to spend $2.5 million dollars each year in additional salaries that would otherwise be devoted to more important IRS activities. The burden is increased by the requirement that certain tax liabilities must be separated into those incurred prior to the filing of the bankruptcy petition and those incurred after, even though the debtor does not separate such liabilities. Currently, there is no prohibition against assessment for those liabilities incurred after bankruptcy and there is no suspension of the statute of limitations on assessment under IRC section 6501(i).

For prepetition liabilities, the statute of limitations on assessment is suspended for the period the automatic stay is in effect and for 60 days after the stay is lifted. The stay is removed as of the date it is lifted, rather than the date the IRS receives notice that the stay is lifted. The statute commences running again whether the IRS knows about the lifting of the stay or not, and without notice the IRS has no way of protecting the revenue by making assessments. The Austin Service Center alone has found several hundred thousand dollars worth of barred statute cases. Thus another aspect of this problem area is that the IRS should be given at least one year to find out that the automatic stay has been lifted to assess the liability. Without such an amendment, there will be lost revenues on deficiencies where IRS did not receive notice of the lifting of the stay and, therefore, had no opportunity to protect the revenue. This problem would be addressed by our proposed amendment to IRC section 6503(i).

The maintenance of tax returns filed that cannot be assessed because of the automatic stay must be done manually, otherwise our data processing system would automatically assess the liability. Additional time and effort is wasted because the automatic stay places the burden on the IRS service centers of blocking the assessment on the computer system and then necessitates manually processing and maintaining all prepetition returns (also those reporting both prepetition and postpetition liabilities on one tax return).

An assessment is merely the recording of a tax liability. When an assessment is made, IRC section 6303(a) requires that a bill be issued advising of the assessment, its amount and demanding payment of the assessment. The taxpayer must know of the liability to contest any erroneous amount and the amount that must be paid to satisfy the liability. The amendment of the Bankruptcy Code that is sought will not allow the IRS to assess a deficiency because the period for petitioning the Tax Court for a redetermination will not begin to run until the automatic stay is lifted.

IRS would still be prohibited from taking acts to collect the liability except for the assessment and the first bill notifying taxpayer of this assessment. This would not give the IRS any advantage over other creditors. The proposed amendments would eliminate a drain of costly resources unnecessarily occurring year after year together with the revenue lost through barred statutes. GAO pointed out this problem in report GGD-83-47, dated June 20, 1983.

Suggested Statutory Language
(Underlining signifies addition)

Section 362(a)(6) of Title 11, U.S. Code is amended by striking out "assess" so that non-deficiency taxes in bankruptcy cases may be assessed.

Section 362(b)(8) of Title 11 should be amended to read: Under subsection (a) of this section, of the issuance to the debtor by a governmental unit of a notice of tax deficiency, or a making of an assessment for any tax and issuance of a notice of such assessment and demand therefor.

Effective Date - The amendment to . 362(a)(6) and (b)(8) shall apply to all proceedings pending on the date of enactment.

Amend section 6503(i) to read:
(1) for assessment, one year thereafter, and

Note: This problem and the proposed statutory solution must be brought to the attention of the Senate Committee on the Judiciary and the House Committee on the Judiciary since the Bankruptcy Code is within their jurisdiction. Of course, it should also be referred to the tax-writing committees for their consideration.

LENDER, SURETY - 25% LIMITATION

Proposal

Amend IRC section 3505 (b) so that the 25% liability limitation relates only to the amount of the tax due. Liability for interest would be in addition to the 25% limitation cap.

Reason for Change

Section 3505(b) provides that a person who supplies funds to an employer for the purpose of paying wages with knowledge that the employer does not intend or will not be able to make timely payment of the required payroll tax is liable for a sum equal to the taxes (together with interest) which were not paid over to the United States. However, the liability is limited to an amount equal to 25% of the amount so supplied. This limitation creates confusion over how to compute the 25% liability. The courts have focused on the language in the limitation which provides that the liability is limited to an amount equal to 25% of the funds so supplied. Therefore, this includes both taxes and interest. It is IRS' position that the 25% limitation does not apply to any interest which may be due. (Treasury Regulations section 31.3505-1(b)(1) and Rev. Proc. 78-13, C.B 1978-1, 591.) However, the courts have held that the 25% limitation applies to interest as well. U.S. v. Intercontinental Industries, 635 F 2d 1215 (9th Cir. 1981): U.S. v. Metro Construction Co., 602 F 2d 879 (9th Cir. 1979).

Suggested Statutory Language

(Underlining signifies addition)

Section 3505(b) is amended to read as follows:

(b) Personal Liability Where Funds are Supplied. - If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25% of the amount so supplied to or for the account of such employer for such purposes, plus the interest accrued on the liability.

AUTHORIZE ADDITIONAL METHODS FOR PAYMENT OF TAXES

Proposal

Amend IRC section 6311(a) to authorize the Secretary to accept payments of tax in additional forms rather than by check and money order only.

Amend IRC section 6311(b) to extend the protections provided to current payments to approved alternative methods of payment.

Amend IRC section 6311 by adding a subsection authorizing the Secretary to prescribe regulations concerning the receipt of tax payments by credit card or other commercially acceptable means; authorizing the Secretary to contract for services with respect to alternative methods of payment; and providing certain basic rules to govern payment by alternative methods.

Reason for Change

The proposal is an attempt to include desirable payment alternatives already used widely by taxpayers in making other payments. No program to accept tax payments by credit card or any other new method of payment will be implemented until and if studies and testing show that a new form of payment would be beneficial to the taxpayer and to the Treasury Department. Even with this showing, the Secretary will proceed with the program only where a cost-effective fee arrangement can be negotiated.

This change would also have a significant impact with respect to electronic filing.

Suggested Statutory Language

(Underlining signifies addition; brackets signify deletion.)

* SEC. 6311. PAYMENT BY CHECK, [or] MONEY ORDER OR OTHER MEANS.

(a) AUTHORITY TO RECEIVE. -- It shall be lawful for the Secretary to receive for internal revenue taxes, or in payment for internal revenue stamps, checks, [or] money orders, or any other commercially acceptable means that the Secretary deems is appropriate, including payment by use of credit cards, to the extent and under the conditions provided in regulations prescribed by the Secretary.

[(b) CHECK OR MONEY ORDER UNPAID.]

[(1)] (b) ULTIMATE LIABILITY. -- If a check, [or] money order, or other method of payment so received is not duly paid, the person by whom such check, or money order, or other method of payment has been tendered shall remain liable for the payment of the tax or for the stamps, and for all legal penalties and additions, to the same extent as if such check, [or] money order, or other method of payment had not been tendered.

[(2)] (c) LIABILITY OF BANKS AND OTHERS. -- If any certified, treasurer's, or cashier's check (or other guaranteed draft), or any money order, or any other means of payment that has been guaranteed by a financial institution (such as a guaranteed credit card transaction) so received is not duly paid, the United States shall, in addition to its right to exact payment from the party originally indebted therefor, have a lien for:

(i) the amount of such check (or draft) upon all the assets of the financial institution on which drawn, [or for]
(ii) the amount of such money order upon all the assets of the issuer thereof, or
(iii) the guaranteed amount of any other transaction upon all the assets of the institution making such guarantee;

and such amount shall be paid out of such assets in preference to any other claims whatsoever against such financial institution, [or] issuer, or guaranteeing institution, except the necessary costs and expenses of administration and the reimbursement of the United States for the amount expended in the redemption of the circulating notes of such financial institution.

(d) PAYMENT BY OTHER MEANS. --

(1) AUTHORITY TO PRESCRIBE REGULATIONS. -- The Secretary shall prescribe such regulations as the Secretary deems necessary to receive payment by commercially acceptable means, including regulations that --

(A) specify which methods of payment by commercially acceptable means will be acceptable,

(B) specify when payment by such means will be considered received,

(C) identify types of non-tax matters related to payment by such means that are to be resolved by persons ultimately liable for payment and financial intermediaries, without the involvement of the Secretary, and

(D) insure that tax matters will be resolved by the Secretary, without the involvement of financial intermediaries.

(2) AUTHORITY TO ENTER INTO CONTRACTS. -- Notwith-standing section 3718(f) of title 31, United States Code, the Secretary is authorized to enter into contracts to obtain services related to receiving payment by other means, and is further authorized to pay any fees required by such contracts.

(3) SPECIAL PROVISIONS FOR USE OF CREDIT CARDS. -- If use of credit cards is accepted as a method of payment of taxes pursuant to subsection (a) --

(A) subject to the provisions of section 6402, any refund due a person who makes a payment by use of a credit card shall be made directly to the person who made such payment, notwithstanding any other provision of law or any contract made pursuant to paragraph (2) of subsection (d);

(B) any credit card transaction shall not be considered a "sales transaction" under the Federal Truth-in-Lending Act (15 U.S.C. 1601 et seq.);

(C) all non-tax matters as defined by regulations promulgated under subparagraph (1)(C) of subsection (d), including billing errors as defined in section 1666(b) of title 15, United States Code, shall be resolved by the person tendering the credit card and the credit card issuer, without the involvement of the Secretary; and

(D) the provisions of section 1666(i) of title 15, United States Code, shall not apply.

SEC. 6201. ASSESSMENT AUTHORITY.

* * * *

(a)(2) UNPAID TAXES PAYABLE BY STAMP. --

* * * *

(B) CHECK, OR MONEY ORDER, OR OTHER METHOD OF PAYMENT NOT DULY PAID. -- In any case in which a check, [or] money order, or other method of payment received under authority of section 6311 as payment for stamps is not duly paid, the unpaid amount may be immediately assessed as if it were a tax imposed by this title, due at the time of such receipt, from the person who tendered such check, or money order [.], or other method of payment.

Chairman PICKLE. Now, the Chair wants to call up as the next panel, Gerald Portney; Arthur Hoffman; and James Holden.

This panel consists of Gerald Portney, who is the gentleman in the center I see. And Mr. Portney is a principal of the KPMG Peat Marwick Co.; Arthur S. Hoffman, chairman of Federal taxation, the executive committee, the American Institute of Certified Public Accountants; and you are accompanied by Mr. Skadden who is the vice president of taxation who has been with us before; and James P. Holden, who is the chairman of the Section on Taxation, representing the American Bar Association.

Well, let us proceed. Mr. Portney, will you proceed first?

STATEMENT OF GERALD G. PORTNEY, ESQ., PRINCIPAL, KPMG, PEAT MARWICK

Mr. PORTNEY. Good morning, sir. Mr. Chairman and members of the subcommittee, if it is agreeable I will not read my statement. I would just like to take my——

Chairman PICKLE. Well, let me just say to all three of you that your entire statements will appear in the record.

Mr. PORTNEY. Thank you, sir.

I think among the fundamental problems that have been presented, Mr. Chairman, to the subcommittee in its examination of the IRS gap research are the significant gaps in the research itself, one of which has been alluded to several times this morning—namely, that it is limited both to income tax and from the legal sector.

I would like to suggest some others perhaps for the committee's consideration. One is that it seems to me that there is an absence, at least one that I perceive, of any meaningful analysis in the possible correlation between the growing serious delinquent accounts receivable problem—which the chairman has alluded to on a number of occasions on the one hand—with other forms of noncompliance, be they related to the filing of returns or nonfiling; the accuracy of returns, and other taxes as well.

Another problem I see is this meaningless $10 million so-called bright line that is drawn between small corporations and large corporations. I do not think that the IRS would seriously argue that a $9 million corporation has anything in the world in common with a $100,000 corporation. So I think that that is something that would be helpful in terms of the future analysis and the problem solving.

Chairman PICKLE. Well, do you have a figure?

Mr. PORTNEY. No, but I think the IRS has a lot of data where it could come up with more subgroupings, Mr. Chairman, that would make more sense, and not be coupling the very, very small business person with what is really a pretty substantial business enterprise.

I also have difficulty in finding where the tax gap research focuses on the bartering economy. Now, in the early 1980's when I was in the Service, that was considered to be a fairly significant problem, that required the Service to deal with it. And yet, it does not appear that it is being acknowledged in any direct way. I also suggest that the taxpayer compliance measurement program audits probably are not effective at all in the identification of the bartering income problem.

I also do not see any evidence that noncompliance is being studied or otherwise approached on a taxpayer basis or a taxpaying entity basis, as distinguished from a functional approach. The Service's functional approach to tax administration may well be the best approach. On the other hand, I think it is a formidable barrier in making many taxpayer contacts which the Service has more productive. For example, in using the approach they use, an IRS examiner or revenue agent, for example, can complete an audit of an income tax return—individual, corporate or whatever—without actually inquiring into whether the taxpayer is current in meeting payroll taxes, if the taxpayer's other payments are otherwise delinquent or current, or if the taxpayer is complying with information reporting requirements.

I think it is also clear that withholding and information reporting are the most efficient means of obtaining compliance with our current tax system. And while withholding, as a mechanism, and the political viability of it is somewhat debatable I would argue that there is a lot more that the IRS can do within its own resources, and without any legislation and within the existing rules to improve the information reporting, and thereby, compliance.

I believe, based upon my personal experience these last almost 7 years, that there is a significant lack of awareness among a variety of organizations and entities, both public and private, not for profit, tax-exempt and others. The General Accounting Office focused on this in its report in May of 1988. Included among those groups are many who were unaware of their information reporting responsibilities as payers. They then became aware of these responsibilities one way or another but since then have been reluctant to commence reporting for fear of triggering substantial and onerous penalties.

Now, this subcommittee, as part of its acknowledged and rightfully so successful penalty reform effort, provided some very sage advice to the IRS as a part of the administrative recommendations. You urged the IRS to join with the payer community in a cooperative and collegial effort to improve the performance of the information reporting system.

And I think it is about time that something like that happened. My suggestion is that the IRS pick up on that sage advice by forming a team—it does not have to be a very big one, and does not have to cost a lot of money—a team with a marketing and customer relations orientation, with a well-thought-out plan that would involve trade associations and State tax administrators and others in a constructive national campaign to bring information providers and payers in as shareholders in our tax system.

I also think that the IRS needs to look at other ways to leverage its resources. It is great to come in and ask for more funds, but sometimes reality says, that is not within reality. I think that the concept of self-auditing is the one that the Service ought to be looking at. It is an appealing one. It would involve the use of carefully designed questionnaires, accompanied by some specific instructional material. It would be directed to selected taxpayers for them to self-audit some specifically designated items which the Service has determined to have a high incidence of error.

And the technique could be used both with returns that the IRS might wish to review, but does not have the resources for; and it could also be used to augment existing examinations that they are conducting.

Would this be a bold step? Perhaps. Is there some risk? Probably. Is it worth pursuing? I think it really is. I think the need for bold action is not just limited to the Service. I think that Congress and the administration need to step up. Simplification is no longer a concept or an idea, but it is a necessity to reduce the hemorrhaging of our tax system.

We have imposed upon our citizens the choices of being either bookkeepers or nonitemizers, or bookkeepers or noncompliers, but bookkeepers nonetheless.

And while some speak with pride at the reduction of the number of individuals itemizing because of tax reform 1986, these same voices seem to be extraordinarily silent about the egregiously complex rules dealing with, among others, interest and passive activities, both of which are also part of tax reform 1986.

In addition, the recordkeeping burden on many larger corporations exceed the common sense needs of the tax system and also are adding costs needlessly to both sides. A year ago the talk inside the beltway was that there was no constituency for simplification. And Mr. Chairman, with all due respect, I do not think that was true. I think the problem has been that there was no leadership for simplification.

And even today as Assistant Secretary of the Treasury Gideon and Commissioner Goldberg address simplification in, I think a sincere and thoughtful way, there is an undercurrent that suggests that simplification is only possible if it either raises revenue or, at the very worst, is revenue neutral.

There are some of us who believe that there is a simplification dividend for the Treasury which cannot be calculated through traditional revenue estimating means. But we think it really is there.

And, finally, Mr. Chairman, I am delighted to hear you express your views with regard to the valuable model of roundtables, which this subcommittee, deserves continuing praise for pioneering. And I would hope that you would put high on your agenda for roundtable discussion and resolution, the employee independent contractor problem, as well as other appropriate controversies which are really draining and diverting valuable resources away from the Internal Revenue Service so that they might be better able to pursue areas of other noncompliance. There are no quick fixes to the very incomplete tax gap picture, but I do hope that there is a willingness to patiently persevere to complete that picture before the solutions are cast in stone.

And I would also make one final postscript suggestion for consideration. This may be a little bit bold but I think it ought to be considered. And that is, on an annual basis, the Service ought to be able to provide, with the General Accounting Office's review and confirmation, a figure which represents the uncollectible portion of the U.S. tax gap.

And I think that number ought to be recorded as a tax expenditure on an annual basis, so that everybody knows exactly what our system is simply incapable of producing.

Thank you, very much, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF GERALD G. PORTNEY

Mr. Chairman and Members of the Subcommittee

I am Gerald G. Portney, a Principal in the firm of KPMG Peat Marwick, in Washington, D.C. Prior to this, my 26-year career in the Internal Revenue Service included the position of District Director for Maryland and the District of Columbia (1974-79); Assistant Commissioner (Technical) (1979-82); and Associate Chief Counsel (Technical) (1982-83).

I appreciate the opportunity to appear before this Subcommittee as you launch a series of hearings on the largest, most difficult to understand, measure, and solve, and most important challenge of our tax system.

You appropriately have pointed out in your press release that (and these are my words) the "Tax Gap" is really not _The_ Tax Gap, for it does not include various categories of taxes (other than income taxes), unpaid taxes from illegal activities, or accounts receivable the amounts of which run high into the billions (though no one seems to know, with confidence, how high).

One of the gaps that should be addressed by the IRS is an informational one. Is there a correlation between taxpayer delinquency as evidenced by the size of the accounts receivable problem and the timely filing and accurate reporting by those same taxpayers?

I think it is important to call attention to what is _not_ included, so that in considering our tax system's true condition, its reality-based viability, and its potential for improvement, we do not mischaracterize the Tax Gap to the American public as a $75 billion net gap or $100 billion gross gap, when in fact it is a gap that cannot be reasonably estimated, that is not only recurring but growing, and that (while it is anybody's guess) could aggregate between $1 trillion and $2 trillion in the decade of the 1980s. If that is possible, imagine what the 1990s may bring.

The most effective methods in place for achieving the compliance levels we have, are withholding and information reporting. Whether it is politically possible to expand withholding is something upon which I cannot even speculate. Therefore, I would like to move on to information reporting.

INFORMATION REPORTING

The IRS is not doing well enough in realizing the potential of information reporting. I have no means of estimating the size of the information return reporting gap that exists under current reporting requirements, but I believe it is significant and most of it falls in two categories:

(1) Payors or others required to report who are truly unaware of specific requirements and whose noncompliance is really inadvertent. There is much to support this conclusion as it relates to state and local governments, school districts, tax-exempts, and not-for-profits. But I believe the same holds true of the private sector. On the other hand, banking institutions, insurance companies, brokerage firms, among others, seem to be doing well, as are large corporations, based on anecdotal evidence.

(2) The second category consists of those who at one time were unaware of their information reporting responsibilities, subsequently became aware, and yet are anticipating severe penalties for coming forward. Having chosen to keep their heads down, they do not understand that by making the decision to perpetuate a formerly unknown error, they have placed themselves into the far more costly "Intentional Disregard" trap.

Mr. Chairman, there is no reason to permit this situation to continue. This Subcommittee, recognizing information providers as unpaid surrogates of the Government in aiding tax compliance, spoke clearly and thoughtfully in its administrative recommendations as part of its Report on the Improved Penalty Administration And Compliance Tax Act (1989). You urged the IRS to work with information providers, to seek their cooperation, and to offer its own cooperation in pursuit of the common goal of improving performance in accordance with the needs of the tax system.

The private sector would consider this a business opportunity and pursue it. With the right team, with a marketing and customer-relations orientation, and a well-thought-out plan that should include the resources of trade associations and state tax administrators, the IRS could achieve superb results within 24 months at a very modest cost.

One more point, relating to the second category I mentioned earlier. Without necessarily using the "A" word (amnesty), might this not be a low-risk way of gaining some insight into what happens if you open the door for a period of time and invite those who have stayed away to enter without an admission charge? This could be approached as an IRS effort to cooperate with the payor community in improving information reporting.

Expansion of current information reporting requirements, in addition to business matching, should be studied using a burdens (on the third-party penalty information provider) and benefits (to the Government) test.

The four major components of the so-called Gross Tax Gap seem to represent the spectrum of difficulty.

Informal suppliers are probably the most difficult, followed by sole proprietors, small corporations, and finally, large corporations.

INFORMAL SUPPLIERS

The identification of those who comprise this taxpayer group is not only critical as a starting point, but also the most difficult category of all tasks. Certainly, with regard to street vendors and others who may require licensing at the local level, there are opportunities for IRS district offices to obtain such data and have it checked against IRS and Social Security Administration computer files. The likelihood of finding adequate records being maintained by individuals in these cases is not very high.

This group, perhaps more than any other, presents the greatest challenge for creativity and innovation.

SOLE PROPRIETORS

Improving and expanding the information reporting program could be a significant step in dealing with the unreported income of sole proprietors. This is an easier and far less costly way to address the unreported income problem of sole proprietors than to discover it through audit.

The identification of these people seems to be a more manageable task, since those who provide services and produce or sell goods, do so from fixed locations and account for the largest portion of underreported taxes.

Within the sole proprietor category, those in the middle income bracket ($25,000 - $100,000) underreported the highest amount of income and had the highest amounts of overstated deductions.

The IRS's special examination emphasis on Schedule "C", (i.e., filers within an amount of $100,000 or more in income) is somewhat inconsistent in light of the data on the $25,000 - $100,000 group, but I suspect the IRS cannot thoroughly cover both, and therefore, probably opts for the most dollars per return audited.

It is not clear, at least to me, how much the IRS knows about the large and diverse sole proprietor category.

While it has been national policy these past ten years to reduce the reporting burden on the public, that policy should thoughtfully be reconsidered where reliable study data prove that the compliance levels of certain groups or classes of taxpayers are lower than the national average.

First, let's take another look at the Schedule "C" and determine what additional information would be useful for both research and compliance purposes. Consideration also should be given to developing a questionnaire directed toward sole proprietors. Perhaps the appropriate trade associations would be willing to participate in this effort, with the Subcommittee using its tried and proven Task Force Roundtables to facilitate the process. Its purpose would be to obtain more information about recordkeeping and reporting practices, use of bookkeeping and accounting assistance, etc.

SMALL CORPORATIONS

The following are among the most significant observations made regarding small corporation tax compliance:

(1) Very limited documentation is available concerning the reasons for noncompliance.

(2) The myriad, often complex tax rules applicable to both Subchapter C and Subchapter S corporations are beyond the ability of many small corporate owners, due to both the professional expertise required, and the cost of that expertise.

(3) Payroll tax deposit rules continue to be a major source of conflict between small corporations and the IRS. The small business sector argues that the rules are unnecessarily complex and burdensome. The IRS often argues that small businesses, among others, compensate for being undercapitalized or for poor management by illegally diverting withheld payroll taxes for other purposes.

If these are, in fact, major contributors to noncompliance by small corporations, then there is promise for at least a partial cure.

Perhaps, the Subcommittee could pursue with the IRS and the small business sector, a proposal for revised deposit rules that would also commit the small business sector to a "best effort" to improve compliance with those rules.

While simplification for small business should be encouraged and pursued, the use of self-auditing techniques also should be considered as a way of leveraging IRS resources. Particular emphasis should be given to those items with a high incidence of errors.

LARGE CORPORATIONS

These should be the easiest to deal with for a variety of reasons. Timing differences constitute a significant element. Timing has become more important to Government since Gramm-Rudman. Since the revenue is not actually lost to the Treasury for the most part, this should not require the priority of attention in the context of being a tax not paid and permanently lost. Also, the largest cases can be individually tracked, providing the most accurate data.

The lack of clarity in the law, and the absence or inadequacy of guidance, give rise to controversy, which is time consuming and expensive for taxpayers as well as the Government. If properly approached and applied, simplification can go a long way. It can reduce unnecessary recordkeeping and record-retention as well as the cost of dealing with controversy. The potential savings in audit and, perhaps, appeals time can be redirected toward other cases, thus improving overall productivity. Where simplification seems unreasonable, achieving certainty should be a high priority, not contingent upon the revenue result.

With regard to faulty records, in reality and in all fairness, the IRS's falling far behind in some of its examinations of large cases aggravates the records problem; with the passage of time, peoples' memories fade -- and given the realities of the business world, the people with the most knowledge on particular events may have since moved on.

The IRS needs to be more committed to becoming more current and should be prepared to make the necessary trade-offs. Until that happens, its criticisms of records and delays must be tempered by its own delays, which contribute to the excess time, expense, and frustration experienced by both sides.

Finally, the $15.8 billion Tax Gap in 1987 attributed to large corporations seems to be of particularly debatable accuracy.

It is my understanding that the IRS's estimate is based on actual examination results, based upon IRS Publication 7285 (3/88) entitled, "Income Tax Compliance Research" - Gross Tax Gap Estimates and Projections for 1973-1992.

Given the IRS's low sustention rates, estimated at 25 cents or less on the dollar, I recommend that this gap figure be clarified before any further consideration by this Subcommittee; and if it turns out that the return examination results were later changed by the appeals and/or litigation process, the IRS should be required to adjust these accordingly.

Mr. Chairman, by the time this series of hearings is concluded, this Subcommittee will have heard from witnesses, all thoughtful, from a variety of sectors, disciplines, and perspectives. But what each of us, and perhaps all of us, will really offer are band-aids, presented as a package of solutions; systems modernization, simplification, more resources, more enforcement, more audit coverage, more taxpayer service, better quality, clearer correspondence, easier forms and instructions are all band-aids, despite the packaging.

The policymakers point with pride at the reduction in the number of taxpayers itemizing in 1987, as a result of the tax reform in 1986, while on April 10, 1990, Roseanne Barr and her TV husband portrayed in a humerous but poignant manner the frustration and cynicism with which many average American families confront their annual tax-filing chore. Very much in evidence was the customary shoe box -- the repository for assorted pieces of paper that must not only be gathered, but sorted, listed, totalled, and then returned to the shoe box to be stored again, just in case.

We have imposed on our citizens the choice of being bookkeepers or non-itemizers -- or bookkeepers or non-compliers.

While forms and instructions may be designed to be understood by those with an eigth grade education, Americans with college degrees cannot understand the interest rules, the passive activity rules, and others (the tax equivalents of rocket science and brain surgery), which have been "brilliantly" conceived as part of Tax Reform 1986.

A year ago, the talk inside the Beltway was that there was no constituency for simplification. Mr. Chairman, that was not true. There simply was no leadership for simplification. Assistant Treasury Secretary Gideon and Commissioner Goldberg are acknowledging and supporting simplification. They, in turn, are going to need help and support. The help must come from business, industry, and professional groups that are prepared to contribute their ideas, proposals, and resources with the clear understanding that simplification is not a euphemism for tax reduction.

Messrs. Gideon and Goldberg are also going to need the support of Congress in clearly communicating its view that simplification is not a euphemism for revenue increases. Nor do I believe they should be constrained by revenue neutrality. The revenue estimation might not agree, but if the rule of common sense together with simplification prevails, the revenues might just take care of themselves.

In the aggregate, simplification may be the only way to preserve the viability of the current income tax system.

While our science and medical researchers diligently pursue the underlying causes of life-threatening diseases so that they may then undertake the arduous task of finding the cures, we who are involved in one way or another with the tax system have a good understanding of what the causes of its health problems really are.

True simplification is a bold step. Let us not fear it because it is so. The employer/independent contractor problem is a current example of a growing, costly, avoidable controversy. It should be clearly designated as a priority for simplification. And, Mr. Chairman, the Subcommittee should use its Task Force Roundtable to grasp this problem and solve it. All it requires is for somebody to just say "Yes".

There are other steps that, given the institutional culture of the IRS, may also seem bold.

> ... Stop looking at the compliance problems of these various groupings of taxpayers in terms of, for example, examination. That is a function of the IRS, but may not tell much about the taxpayer. The accuracy of the income tax return is one measure. The ability to maintain adequate records is another. Filing payroll and other returns is yet another, as is depositing of taxes. Issuing W-2's and information returns are others. The IRS should look at taxpayers from a compliance perspective.
>
> ... The development and use of self-auditing techniques is a way of expanding coverage without commensurate increases in staffing. It is a way to leverage IRS resources. It is worth testing.
>
> ... Substitute a correspondence/telephone audit combination for the current and long-standing office audit program. The use of correspondence should increase productivity while incorporating the person-to-person contact advantage. It is worth testing.
>
> ... Try a new approach to dealing with small business. Let's call the occupation "Small Business Tax Specialist," whose job it is to help these taxpayers cope and who is rated on the basis of the taxpayer's success in becoming a better informed business person with improved compliance performance results. This is a case where both the taxpayer and small business tax specialist share the common objective of improving compliance performance. It is worth testing.
>
> ... IRS management has to reach out more and establish not only contact, but more important, active communication with the outside world. They do not achieve the true value of this and the opportunities to learn as well as to inform. The nation's largest enforcement agency is not well served by that label. If the IRS is the enforcer, what does that say about its constituency?

> They should be quite satisfied as the nation's premier agency for tax administration.
>
> ... The IRS should cease and desist from responding to criticism by saying, in effect, "we are a big organization with 120,000 employees, and we are bound to make mistakes." The number of employees is not material; it often is just one person who fouled up, not 120,000, and if Commissioners of Internal Revenue continue to link the IRS's mistakes to the number of employees, it might occur to people that further increases in people will produce further increases in mistakes.

SUMMARY

Mr. Chairman and Members of the Subcommittee; the Tax Gap, whatever it includes or does not include, is the mirror that reflects major problems with the tax system. That we obtain as much as we do, is affected significantly by the Federal tax deposit system and information reporting.

I would urge three things:

(1) The IRS should attempt to estimate the Tax Gap in the true sense, instead of limiting it by type and sector and between gross and net.

Having done that,

(2) It should apply the best methodology to determine how much is collectible and at what marginal cost, permitting Congress to consider the unreachable portion as a tax expenditure.

(3) And finally, based upon the foregoing, Congress should consider whether this is the best way to raise revenue.

Mr. Chairman, the task that this Subcommittee has undertaken is as difficult as any that could be imagined. It has taken many years and many people to create what is so cryptically called the "Tax Gap."

It is indeed tempting, and perhaps just plain human nature, to move quickly to solutions that too often turn out to be responses to symptoms rather than solutions to underlying problems.

The hearings are helpful. The Task Force Roundtables have demonstrated their effectiveness at problem analysis, problem solving, and consensus building. You have the formula. You have a great deal of support.

Thank you for this opportunity.

Chairman PICKLE. Have you made the suggestions to the Internal Revenue Service about the report at the end of the year?

Mr. PORTNEY. About the what, sir?

Chairman PICKLE. Have you made that suggestion to the Internal Revenue Service that you require a certain amount of reporting at the end of the year of the uncollectible and count it as a tax expenditure?

Mr. PORTNEY. No, I have not.

Chairman PICKLE. We will do so through this testimony. And I appreciate your comments, Mr. Portney, about the possibility of getting a group together for this roundtable, a group that could give to the Internal Revenue their suggestions about how we might have more fairness and perhaps more simplification too.

But I thank you for your testimony.

Mr. PORTNEY. Thank you.

Chairman PICKLE. Now, we are going to hear from Arthur Hoffman.

Mr. Hoffman.

STATEMENT OF ARTHUR S. HOFFMAN, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY DONALD H. SKADDEN, VICE PRESIDENT, TAXATION

Mr. HOFFMAN. Thank you, Mr. Chairman.

I appreciate your invitation to testify during the hearings on the tax gap. I am Arthur S. Hoffman, chairman of the executive committee of the Federal tax division of the American Institute of Certified Public Accountants. Joining me is Donald H. Skadden, who is vice president of taxation of the American Institute.

The AICPA's concern about the tax gap is long standing. We issued and widely circulated a study "Under-Reported Taxable Income: The Problem and Possible Solutions" in January 1983. The task force that produced the study was chaired by Dr. Skadden. We have given copies of it to the subcommittee as a supplement to our testimony, and its relevant recommendations are included in our written comments.

Now, despite the continued existence of a tax gap, we do take some satisfaction that certain recommendations in that 7-year-old study were adopted. The IRS did redirect its efforts toward the underground economy. For example, it focused examinations on schedules C and F income.

Civil tax penalties were revised last year as a result of the outstanding efforts of this subcommittee. Withholding is required on dividends and interest income, where taxpayer identification numbers are not provided to payers. And education of the public has increased. The current Commissioner Fred Goldberg and his predecessor Larry Gibbs have reached out to the public and given service and education a high priority. Unfortunately the tax gap, to some extent, is intrinsic to a free society and a voluntary tax system.

But no one who is concerned about fairness among taxpayers and the dire need for revenues would argue that the efforts to close the tax gap should not intensify. That leads me to make a few observations about the effectiveness of the IRS and the role of Congress before I offer some specific recommendations.

Critics of the IRS cite the fact that examinations of tax returns, as we heard today have fallen to 1 percent of returns filed. The IRS matching program of third-party reporting is not considered in the tax examination numbers. Not to do so distorts the facts. The matching program now is, and should be a cornerstone of our tax system.

The AICPA does not have to tell this subcommittee that the reporting of income is far more likely when the taxpayer knows that the Government has been notified of his receipt.

Years ago it was said and taxpayers assume that all of those slips of paper, those reports, the 1099's were housed in a gigantic Government warehouse never to register upon human intelligence.

However, in recent years it is said that the computerized matching program is virtually sure of detecting failures to report. The fact is that compliance with and enforcement of the tax law is computer oriented. No accounting firm could perform its compliance functions these days, without regularly upgrading its computer resources. The IRS, as the enforcement agency, cannot review returns which report $1 trillion of tax liability, match data from third parties, select returns for examination, assign agents and follow up collection efforts without upgrading its computer resources.

The IRS is developing the tax system modernization program, the TSM, which will require multiyear funding commitments. This subcommittee regularly monitors IRS progress through GAO assessments. The AICPA believes that it is absolutely imperative that the IRS complete the TSM proposal and then be given the financing to implement the program. In addition, IRS must have the funding to increase the quality and training of its people. And why is this so compelling?

The moment the American taxpayer perceives that the IRS is overwhelmed and cannot efficiently crosscheck information and assign agents and follow up assessments, that is the precise moment when the tax gap goes off the charts and becomes immeasurable.

And at that moment also our tax system will lose all claim to being fair and effective, and voluntary compliance will suffer a massive setback.

Now, let me get to my specific recommendations.

On informational reporting which I mentioned before, closing the tax gap depends to a large extent upon expansion of third party reporting. The IRS' list of information returns covers many forms of income and cash transactions from interest and dividends to sale of real property, to gambling winnings and currency handled by casinos. But as we have a tax gap, so too, do we have an information gap.

As to corporations: most information returns relate to payments to individuals. We believe that information reporting should include some payments to corporations where information available to the Government is otherwise deficient, and I believe that we heard today that they know where it is otherwise deficient.

On payments received, not payments made, but payments received, mortgage payments received by banks are reported but otherwise the reporting of payments received are rare. This form of reporting by recipients which serves to confirm the amount of the payer's tax related expense, should be made by States and local governments for real estate, income and property taxes, by lending institutions for interest received on commercial and consumer loans; the list readily can be expanded upon further analysis.

On capital improvements and leases, as a general rule we do not believe that requiring reporting from the average citizen in a nonbusiness context will be productive. However, direct questions asked on the form 1040 should produce a positive response. We suggest that you consider the reporting of payments for capital improvements to residences—that is reasonable because you need a long-term record of the capital improvements to residences at the time of the ultimate sale—and of rent payments above certain thresholds. Contractors, landlords, et alia, should be required to list their taxpayer ID numbers on their contracts and their leases and their licenses, etc.

On commercial purchases we recommend that you consider the reporting of sales by commercial suppliers to commercial purchasers of merchandise, construction materials, et cetera. In addition, landlords could report rents paid by their commercial tenants. The threshold level should be high at first to test the procedure.

The purpose would be to identify commercial activities and their range of volume and not to directly prove the deductions appearing on the tax returns.

As to currency reform, cash transactions are the natural environment of tax evasion. We live in a credit card society for most major transactions. Where such transactions involve cash, beware. There are cash transaction reporting requirements at the $10,000 level by banks. But the unscrupulous stay from scrupulous banks. We must learn more about currency transactions.

We know of no compelling reason to have $100 bills in circulation, other than to facilitate societal mischief. We recommend that Congress withdraw $100 bills from circulation. The exchanges of currency would result in the immediate increase of the reporting of over $10,000 transactions and would make future cash transactions inconvenient for many who deserve to be inconvenienced. Incidentally we suggest that the $10,000 reporting threshold should be reduced at least during this mandatory exchange period.

As to IRS funding, the administration and this subcommittee are being responsive to the current operating needs of the IRS. But let us get on with the planning and the funding of the TSM program.

Reliance on the hordes of data processes and examining agents to enforce compliance is as obsolete as preparing complex tax returns by hand. No agency can rely upon old methods and old computer systems.

On public education, pamphlets prepared by IRS describing the tax system, its inherent fairness if all comply, taxpayer obligations and provisions applicable to various classes of taxpayers should be distributed far more widely—to newly licensed businesses, to schools, to citizenship classes, to retirees, to industry segments based upon the reported industry codes, et cetera.

Additional specific recommendations and discussion are included in the study which I referred to previously and in our written comments.

One last point which the AICPA has often made before the House Ways and Means Committee: compliance depends upon respect for the tax system. Undue complexity makes for disdain of the system. And change of the tax law, itself, is complexity. We urge Congress to be slow to change the tax law, except for changes carefully designed to simplify provisions of wide application.

Incidentally we applaud Chairman Rostenkowski for inviting submissions of simplification proposals. The AICPA will submit a comprehensive package of simplification proposals and if the tax law is made more simple for the great mass of taxpayers, the tax gap surely will narrow.

In conclusion, Mr. Chairman, last year we had the privilege of testifying before this subcommittee on the subject of reform of civil tax penalties and you encouraged the formation of a roundtable group to solve the problems and recommend legislation. You did that again today. The collegial approach last year was a roaring success.

We urge you to have a followup to the proposal this time around as well, to solving the tax gap problem. The AICPA's tax division would be delighted to participate as we did last year, and we do predict another success.

Thank you.

[The prepared statement and attachment follow:]

TESTIMONY OF ARTHUR S. HOFFMAN
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Introduction

General Remarks

Mr. Chairman, I appreciate your invitation to testify during this hearing on the "tax gap" and taxpayer noncompliance. I am Arthur S. Hoffman, Chairman of the Executive Committee for the Federal Tax Division of the American Institute of Certified Public Accountants (AICPA). Joining me is Donald H. Skadden, Vice President - Taxation of the AICPA.

The AICPA is the national, professional organization of certified public accountants (CPA), with over 296,000 members. Many of our members are tax practitioners who work with millions of American businesses and individual taxpayers. We are deeply concerned with the impact of taxpayer noncompliance on the U.S. self-assessment tax system. This concern about the "tax gap" is long-standing. We issued, and widely-circulated, a study Underreported Taxable Income: The Problem and Possible Solutions, in January 1983. The task force that produced the study was chaired by Dr. Skadden. We have provided copies of the study to subcommittee staff, and some of its relevant recommendations are included in our written statement.

Despite the continued existence of the "tax gap," we do take some satisfaction that certain recommendations in our 1983 study were adopted:

- The Internal Revenue Service (IRS) redirected efforts toward the underground economy. For example, it focused examinations on Schedule C and F income.
- Civil tax penalties were revised last year as a result of the outstanding efforts of this Subcommittee.
- Withholding is required on dividends and interest income, where taxpayer identification numbers are not provided to payors.
- Education of the public has increased. Fred Goldberg, Commissioner of Internal Revenue, and his predecessor Larry Gibbs have reached out to the public and given service and education high priority.

It is now widely recognized that loss of tax revenue from the "tax gap" is a major problem in the tax system. The so-called tax gap is enormous by anyone's estimate and is growing larger. The AICPA has not attempted to measure the magnitude of the tax gap, nor do we endorse the methodologies or results of any tax gap studies. However, as indicated in all the studies, we do agree that this is a serious problem that needs prompt attention.

As citizens, and as tax practitioners, CPAs are concerned with the growing inequities among citizens caused by tax noncompliance. Also, CPAs understand and appreciate the importance of preserving the viability of the voluntary compliance system.

Unfortunately, the tax gap to some extent is intrinsic to a free society and a voluntary tax system. No one who is concerned about fairness among taxpayers and the dire need for revenues would argue that the efforts to close the tax gap should not intensify.

Tax Gap Defined

For purposes of this hearing, the "tax gap" has been defined as the difference between the amount of taxes voluntarily paid in a taxable year and the amount of taxes that would have been paid if all taxpayers had filed complete and accurate returns.

The AICPA is concerned that the terminology "complete and accurate return" is misleading. There are many "grey areas" of law where it is difficult to determine the "correct" tax treatment of an item. Consequently, CPAs frequently advise clients on a position to be taken on a return based on an interpretation of the law. The AICPA Statements of Responsibilities in Tax Practice provides that a CPA should not recommend to a client a position unless the CPA has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged. Further, the current penalty laws greatly encourage the disclosure of "debatable" items.

Despite the care and diligence expended in arriving at a conclusion, the IRS, in some instances, may challenge the taxpayer's interpretation of the law and the resulting tax treatment. Administrative or judicial proceedings may be required to determine the "correct" treatment. The definition of "tax gap" does not adequately consider situations where legitimate differences of opinion exist between taxpayers and the government. Perhaps it would be more appropriate to define "tax gap" as the difference between the tax collected and the tax that should have been collected for a given year. This would be a much smaller, but more meaningful, number than the present tax gap estimate.

Possible Causes of Tax Noncompliance

Contributing Factors

Tax noncompliance is susceptible neither to precise measurement nor to definitive analysis. Although it is difficult to discern exactly why more and more people are underpaying their taxes, several contributing factors can be identified:

- The extreme complexity of the tax law and regulations make it literally impossible for many taxpayers to be able to determine the amount of tax they owe.
- The increasing complexity of the tax law can erode public confidence that the tax law is treating everyone fairly. The uneasy, perhaps even subconscious, feeling that others are escaping tax can be used as a rationalization for cutting a few corners.
- Closely related to, and a substantial cause of, the complex tax law is the use of the Internal Revenue Code to motivate or impede certain social and economic activities. What Congress intends as a tax incentive may be perceived as a tax loophole by some who are not in a position to utilize that particular provision. The perception that Congress is intentionally allowing wealthy taxpayers and big business to escape taxes legally can be a strong motivation for others to create their own tax savings.
- The increasing media attention to the tax gap problem may turn into a self-fulfilling prophecy. It becomes easier to rationalize tax cheating on the grounds that "everyone else is doing it."
- It is widely publicized that the IRS only audits approximately one percent of individual taxpayer returns. There is a growing perception that tax cheats will not get caught.
- The changes in social morels and general morality that have been evident in many walks of life also have had an impact in the tax arena. Many people seem to have less confidence in, and respect for, many of society's institutions, including government, the church, universities, big business, and big labor.

- Some perceive that the IRS enforcement practices are applied in an uneven and inequitable fashion, whereby low- and middle-income taxpayers are harassed over small amounts, while insufficient attention is paid to the wealthy and especially to nonfilers.

- Increasing government rules and regulations and payroll taxes provide motivation for many businesses to keep employees off the books.

- A perception--whether correct or not--of widespread waste and inefficiencies in government is often used by some to justify their tax noncompliance.

- There may well be a lack of understanding on the part of many taxpayers as to: the fact that underground types of income are taxable; what constitutes a legitimate tax deduction or credit; the risk involved in the failure to fully report; and the serious impact the underground economy can have upon society.

Congress and Tax Law Stability

In the past twenty-five years, twenty-seven major revenue acts have been enacted which significantly affecting the tax law. The frequency and scope of these changes has surpassed the ability of the Secretary of the Treasury to issue timely and adequate guidance, and taxpayers have been left to determine their tax obligations as best they can.

In order for the current tax system to work, it must generally be self-administrable. Citizens must have trust in the system, confidence that the system is sound and fair, and a general level of understanding of the law.

The frequency of change and the level of complexity created threatens to erode these foundations of the voluntary tax compliance system. As confusion and frustration levels rise, citizens are increasingly tempted to ignore or avoid compliance with the tax law. Many are unable or unwilling to devote the resources necessary to understand all of the new provisions. Others suspect that the IRS will not be able to understand or administer the new provisions well enough to discover the noncompliance. A few have even developed the impression that understanding the tax laws only serves to increase the amount of taxes they must pay.

Further, taxpayer confidence in the system is reduced as legislation is enacted merely as a source of additional or accelerated government revenue rather than for "good tax policy" reasons. Some of the recent legislation has been viewed as unfair, inefficient, and arbitrary. For example, recent changes with the definition of taxable income (elimination of bad debt reserve, uniform capitalization of inventory costs, year end conformity, etc.) seem to serve no other purpose than to accelerate the collection of tax revenue. Revenue over the long-term remains unchanged. These changes merely create a premature recognition of income while at the same time deferring recognition of expenses. These one-time government revenue enhancements result in lifetime headaches for taxpayers.

The tax law will, and should, change with the times. However, for the sake of tax administration, professional preparers, and the taxpaying public, consideration of proposed legislative changes should include review of the potential effect of the proposal on the complexity of the tax system. Simplification, efficiency, and predictability must be given greater priority in the legislative and regulatory process. The AICPA urges Congress to be slow to change the tax law, except for changes carefully designed to simplify provisions of wide application.

Ann Landers in her April 8, 1990 column included a letter from an accountant which quoted two paragraphs from the passive loss regulations. Ann responded, "what you have sent would be hilarious if it weren't so dumb. Every accountant who is fed up with this totally incomprehensible gobbledygook should tear this column out of the paper, scribble across it "I agree" and send it to the AICPA." She further stated, "If a huge number of letters arrive, they will be forwarded to Chicago's own Dan Rostenkowski, chairman of the House Ways and Means Committee, which is where all these laws are written. You can bet your bottom dollar that Danny Boy will put an end to this craziness."

In the first week after the column appeared, the AICPA received over 9,000 responses. These responses will be forwarded to Chairman Rostenkowski. The AICPA believes that if the tax law is made more simple for the great mass of taxpayers, the tax gap would surely narrow. We applaud Chairman Rostenkowski for requesting submissions of simplification proposals as a part of a "major tax simplification study." The AICPA will submit a comprehensive package of tax simplification recommendations in response.

Recommendations

Internal Revenue Service Modernization

Critics of the IRS cite the fact that examinations of tax returns have fallen to one percent of returns filed. The IRS matching of third party reports with taxpayers' returns is not considered in the tax examination numbers. Not to do so distorts the facts. The matching program is and should be a cornerstone of our tax system. In recent years, the computerized matching program is said to be virtually sure to detect failures to report. The fact is that compliance with and enforcement of the tax law is computer oriented.

To deal with the tax gap, the IRS needs additional informational reporting, and it needs the means to be able to use this information. The IRS computer system was designed in the 1950's. The IRS has stated that it anticipates a serious computer capacity shortage by the mid-1990's if its current system is not modernized.

The IRS is developing the Tax System Modernization Program (TSM) which will require multi-year funding commitments. The Subcommittee on Oversight regularly monitors IRS progress through General Accounting Office assessments. The AICPA believes that it is absolutely imperative that the IRS complete the TSM proposal and then be given the financing to implement the program. In addition, the IRS must have the funding to increase the quality and training of its people.

Systems modernization is a long-term effort that will require many years and significant capital investment to complete. Modernization of the system will also result in improved taxpayer services and satisfaction.

Expanded Informational Reporting

It is clear that some types of income are more easily understated or omitted from a tax return than others. Thus, tax noncompliance thrives on income not subject to withholding or to informational reporting. Currency transactions are easier to hide from the tax collector than business conducted by checks. Both currency and checks are more susceptible to underreporting than are credit card transactions. Barter transactions bypass all records--currency, checks, and credit cards--and are the most difficult to detect.

Closing the tax gap depends, to a large extent, upon expansion of third-party reporting. History has shown that the level of tax compliance improves when the individual knows that the IRS has, or will have, information about the transaction or activity. The IRS currently receives information from a variety of sources, including the various Forms 1099; informational schedules on tax returns, such as the partnership and S corporation schedule Ks; and answers to questions on the many types of tax returns.

Presently, anyone in a trade or business is required to file a Form 1099 for certain types of payments in excess of $600, but only if those payments are made to individuals. Such reporting could be extended to include some payments made by businesses to corporations where the information available to the government is otherwise deficient. If this produces an unwieldy flood of paper to the IRS or an unreasonable burden on the business community, a higher threshold might be adopted. Magnetic filing of these reports could also be encouraged. In order to facilitate IRS matching of informational returns with amounts declared on the recipient's tax return, a listing of such payments, which exceed a reasonable threshold, could be required in the tax return of the recipient.

Currently, mortgage payments received by banks are reported, but, otherwise, the reporting of other tax-related payments received is rare. This form of reporting by recipients, which serves to confirm the amount of the payor's tax-related expense, could be made by: State and local governments for real estate, income and property taxes; and lending institutions for interest received on commercial and consumer loans. This list can readily be expanded upon further analysis.

Some states have adopted a requirement that anyone claiming certain types of credits or deductions on the state income tax return must provide the name, address, and ID number of the payment recipient. The Federal government has a somewhat similar requirement for taxpayers claiming a credit for child or dependent care. This requirement might be extended to include other credits or deductions for payments above a reasonable threshold. Consideration might be given to allowing partial deductions or credits for certain types of payments which historically contribute to tax noncompliance. In order to get the tax benefit, the taxpayer would need to provide information about the recipient.

For example, Congress might consider allowing a partial deduction of rent payments where the taxpayer provides the name and address of the landlord.

Several factors of informational reporting must be considered. The benefits are both real and psychological; real in the sense that the matching process can reveal tax noncompliance, and psychological in the sense that the taxpayer who knows that an item has been reported to the IRS is more likely to include it on the Form 1040. Both benefits are reduced, however, if the IRS does not have sufficient manpower and computer facilities to match and follow up on the information received.

Internal Revenue Service Budget

The AICPA is aware of the limitations placed on the IRS by insufficient operating budget allocations. Insufficient appropriations obviously affect the allocation of resources to various functional areas, such as taxpayer audits, and hinder IRS efforts to cure the tax noncompliance problem. This not only affects the operations of the IRS, but also taxpayers' perceptions of the IRS.

The IRS in the past two years has faced funding shortfalls, as a result the IRS implemented a hiring freeze, curtailed promotions, cut back support services, and reduced compliance programs. Those actions reduced revenues and led to curtailed service.

More and better enforcement is needed and desirable. However, no one knows or can predict the level of enforcement that would be necessary to change the noncompliance situation appreciably. Congress should authorize additional operating resources for the IRS with the mandate that these resources be used for enforcement, which is the first step in tackling the tax noncompliance problem. While the mood of the country today seems to favor smaller federal budgets and less government interference, it is likely that the large majority of citizens who are filing proper tax returns would welcome increased surveillance of those who are underpaying their tax. Although reduced federal spending may be generally desirable, an increase in the IRS' budget will pay for itself through improved compliance and adjustments to returns which are examined.

However, better enforcement efforts must be tempered with consideration of what level of government surveillance and investigation the American people are willing to accept. We can not allow the cure to become worse than the disease.

Taxpayer Education

Some individuals may underreport income simply because they do not understand that the income should be reported. In addition, even those individuals who know they are underpaying their tax may not understand all the potential consequences to themselves or to society.

Enhanced IRS education programs might be as effective as major increases in enforcement activities and would very likely be more acceptable to the American public.

The government should increase its education efforts. A concerted effort should be made to counter the negative publicity given tax noncompliance. More publicity should be given to the number of returns filed, the amount of tax paid, and the relatively high level of voluntary compliance. The IRS should better publicize its enforcement activities and the results thereof. Included in this publicity effort should be explanations of the matching, math checks, DIF comparisons, and other procedures a return is subjected to, even if no audit results.

Special efforts could be directed at those groups more likely to be noncompliers. Instructions for the various tax returns, as well as releases to the popular media, could be used to explain that bartering and currency transactions are to be reported. Pamphlets prepared by the IRS describing the tax system, its inherent fairness if all comply, taxpayer obligations and provisions applicable to classes of taxpayers should be distributed far more widely to: Newly licensed businesses; schools; citizenship classes; and retirees.

It is highly unlikely, however, that government educational programs alone will be sufficient. Statements from the government are often considered to be self-serving and are viewed by many citizens with a great deal of skepticism. Any effort to modify the public's views toward the tax system and toward responsibilities to society and to government would be far more effective if it were sponsored by groups outside of government.

Such an effort would indeed be a major undertaking, requiring the resources of many groups, and it would be far more effective if it were a cooperative venture involving a wide variety of different types of organizations.

Such an educational program should utilize all media and should emphasize such points as: The present voluntary compliance system is valuable and should be preserved; the large majority of taxpayers do pay their tax; most so-called loopholes are really incentives approved by Congress to improve our economic and social structures; the typical underground transactions are indeed taxable, should be reported, and are reported by most taxpayers; the possible consequences of participating in tax noncompliance include both personal risks and institutional consequences of excessive government enforcement; and, we cannot "cheat the government"--any underpayment simply adds to the burden of fellow citizens.

Public attitudes in other problem areas, such as smoking and drunk driving, have changed as a result of educational efforts. With broad private-sector leadership, the moral climate concerning tax noncompliance can be changed.

Suggestions for Consideration

Commercial Supplier Reporting

A different approach to third-party reporting which Congress may wish to consider would be to require commercial suppliers to report sales to commercial purchasers. These reports could then be matched to the cost of sales reported on the purchasers tax return. Profit margin computations could be performed on such cost figures as a means of verifying that a corresponding level of income has been reported on the tax return. The requirement could be implemented at a higher annual threshold initially. If successful, a lower threshold could be phased-in.

Copies of any reports supplied to the government should be provided to the purchaser. If taxpayers are aware that reports have been filed which indicate the general volume of business, it should reduce the temptation to "skim" sales revenue. Since amounts purchased from numerous suppliers (above and below the established threshold) would be lumped together in a single cost of sales amount, matching by the IRS would be virtually impossible. Requiring a list of such purchases in excess of the established threshold would be one possible means of facilitating such matching.

This might be a unique approach to increasing tax compliance in certain occupational and industry groups where tax noncompliance is believed to proliferate, such as residential home improvements and construction.

Currency Reform

There is another long-range approach not commonly considered. Although it is removed from the tax arena, intuitively it would seem to be worthy of consideration as a possible deterrent to tax noncompliance. In the modern world of computers and other electronic devices, the need for cash is reduced and may eventually be eliminated. Credit cards, electronic fund transfers, paying bills by telephone, and shopping via cable television have all been suggested as the "way of the future." It might be worthwhile for the government to take steps to encourage those developments and hasten the day when we might need relatively little currency in circulation.

An experiment along these lines that the government might try in the near future would be to withdraw from circulation all bills larger than the $50 bill. In a widespread but completely unscientific survey of people in the business community, we have found no evidence that any legitimate economic activity would be seriously disrupted if there were no $100 bills in circulation. Yet, the number of $100 bills in circulation has increased far more rapidly than any other denomination. If it can be presumed that most of these bills find their way into both the informal (legal activity which goes unreported) and illegal segments of the underground economy, the absence of such currency could be a deterrent to those activities.

If it is deemed necessary or desirable to have $100 bills in our currency system, an approach used in Switzerland might be used to produce some of the same benefits. Under the Swiss system the $100 bills, and perhaps the $50 bills, would expire periodically. Anyone holding such currency would be required to exchange it at a bank. This approach would bring large hoards of these bills to the surface. Any exchange of these bills over a threshold amount could be reported to the IRS and procedures instituted to determine that tax had been paid on these funds.

Miscellaneous Suggestions

The following are additional suggestions that should be considered: Tax deductions might be denied for cash payments (other than W-2 type wages) above a reasonable threshold; reporting of capital expenditures, including additions to the basis of residential or other property might be mandatory and could require the reporting of the suppliers name and ID number; deduction of the cost of incentives or prizes might be denied if the value is not included in a Form 1099 or W-2; and, questions could be added to the individual 1040, Schedule C regarding any bartering or currency transactions.

Conclusion

Mr. Chairman, last year, we had the privilege of testifying before the Subcommittee on Oversight on the subject of reform of civil tax penalties. You initiated a unique and effective mechanism for developing legislation. The collegial roundtables involved all interested parties and were a tremendous success. We urge you to authorize the same approach to solving the tax gap and taxpayer noncompliance problem. The AICPA would be delighted to participate in such an effort, and we predict another success.

Underreported Taxable Income: The Problem and Possible Solutions

Federal Taxation Division

JANUARY 1983

AICPA **American Institute of Certified Public Accountants**
1620 Eye Street, N.W., Washington, D.C. 20006

FOREWORD

In late 1979, the AICPA Federal Tax Division formed a task force, under the direction of the Tax Policy Subcommittee, to study the problems of tax revenue losses due to underreported income. The objective was to consider the various problems and issues and to present recommendations for possible approaches to improve reporting of income. This report embodies the results of the task force study.

It is now widely recognized that loss of tax revenue from underreported income (also referred to as the compliance gap, the underground economy, the hidden economy) is a major problem in the tax system. The so-called tax gap is enormous by anyone's estimate and is growing larger. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) includes many measures aimed at reducing this revenue loss. Some of the possible solutions discussed in this study have been adopted in TEFRA; others have not. This study is offered as a contribution to the ongoing debate about the problem of underreported income.

Over two years of dedicated work went into the development of this study, and the members of the task force —

Donald H. Skadden, Chairman
John Gilbert
Donald M. Tannenbaum
Rufus Hardy

have earned the appreciation of the AICPA Federal Tax Division. Mr. Skadden's tireless efforts, in particular, were instrumental in completing the study. The recommendations presented have been approved by the Tax Policy Subcommittee and the Executive Committee of the AICPA federal tax division. The members of these bodies in 1982, when the report was approved, were:

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INTRODUCTION

The intentional underpayment of taxes is certainly not a new phenomenon. It has been a common problem since biblical times. The scope and magnitude of the problem have varied from time to time and from country to country, but underpayment has been a serious concern for centuries. The citizens' attitudes and their inclination to underpay can vary from one type of tax to another. For example, within the United States the high level of noncompliance with the personal property tax has caused many jurisdictions either to abolish or modify that system; however, during this same time span there has been a high degree of voluntary compliance with the self-assessed income tax.

Since World War II, however, voluntary compliance in the United States has deteriorated, and during the past ten or fifteen years this unfortunate development has reached serious proportions. Various studies indicate that the federal tax shortfall due to the underreporting of income may be as high as $70 billion to $120 billion. If such amounts were collected in full, the federal budget could be balanced and/or tax rates could be decreased significantly. This situation presents a serious equity issue: The honest taxpayers are bearing an ever-increasing burden because of the growing number of citizens who are not paying their full tax. This can easily become a self-perpetuating cycle. As the honest taxpayers' burden increases, the growing inequity of the situation may convince them that they are paying an unfair share. This, in turn, could motivate more of them to join that segment of society that is not paying what the law requires, and might ultimately lead to the breakdown of the voluntary compliance system itself.

In addition, if the situation continues to worsen, it could lead to the disruption of our economy and even to a breakdown in society if Congress finds itself unable to raise sufficient revenue. In all likelihood, if the situation threatens to approach such proportions, Congress will feel compelled to adopt a system quite different from the self-assessment system we have enjoyed for so many years.

The Federal Tax Division of the American Institute of CPAs has recognized that CPAs have valid reasons to be concerned about this situation. Accountants are concerned with the growing inequities among citizens and have a professional interest in maintaining the viability of the voluntary compliance system.

This report addresses the terminology and scope of the problem, the nature of underground income, possible causes of underreporting, the situation abroad, public opinion, and possible ways to alleviate the problem. An extensive bibliography and a list of references include citations to significant articles, books, and special studies related to the underground economy. The parenthetic numbers in the text refer to the corresponding items in the list of references.

SUMMARY OF RECOMMENDED ACTIONS

While it is recognized that underreporting of income will never be completely cured, this report suggests several specific actions that could help alleviate the inequities and contain the growth of the underground economy. The areas of concern, types of recommendations, and some of the specific suggestions are outlined below.

Enforcement activities

- The IRS should redirect some of its efforts toward the underground economy.

Penalties

- Current penalties for both civil and criminal fraud should be reexamined.

Informational reporting

- Reporting should be extended to include business payments to corporations, transactions with barter exchanges, auction houses, dealers in collectibles, and large currency transactions.
- Tax returns should be modified to provide more information and to ease matching with informational forms.

Withholding should be required on —

- Business payments to independent contractors.
- Interest and dividend payments. (The government should bear the administrative burden or the cost thereof.)

- Taxable pension payments.
- State tax refunds.

Currency reform

- Encouraging the use of checks and credit cards and discouraging the use of currency might deter transactions that are common to certain facets of the underground economy.

Tip income

- A special conference should be held to explore new and innovative approaches to this perplexing problem area.

Education programs

- It is probable that some taxpayers underreport income because they do not understand that —
  - The income is taxable.
  - The risk they are running by underreporting is significant.
  - Their actions have consequences for the economy and the country.
- The IRS should expand and improve its educational efforts.
- Some educational efforts would have greater credibility and acceptance if provided by groups outside the government.

Therefore, the AICPA should seek to enlist the support of other organizations in an effort to conduct an extensive national education program.

TERMINOLOGY AND SCOPE OF THE PROBLEM

Several labels have been coined for that part of the economy that consists of income concealed from the tax collectors. The most common seems to be "underground economy"; authors have also used "subterranean," "clandestine," "irregular," and "hidden" economy. The Internal Revenue Service has subdivided the area into the "illegal economy" and the "informal economy." Illegal describes the underlying transactions and includes prostitution, gambling, drugs, extortion, embezzlement, and the like. In the informal economy, the activities are legal but are not reported properly, or not reported at all, for tax purposes.

The charge to the Task Force was to examine only the informal segment of the underground economy to determine how the accounting profession could assist in alleviating the problem and what additional measures the government or others could take to improve compliance with the income tax statutes.

We have not attempted to measure the dollar volume of the underground economy. The several studies that undertook that task have shown widely varying results, but all of them indicate that the problem is serious enough to deserve the attention of CPAs and other responsible citizens.

The earliest relevant study was reported in 1977 by Peter M. Gutmann, an economist from Baruch College of the City University of New York (11, 12, 13). He estimated that approximately $176 billion in income was going unreported in 1976, approximately one third of it from illegal activities and the other two thirds from the informal economy. Gutmann's estimates were based on an examination of the stock of money (M1), composed of currency plus demand deposits. Gutmann stated that from 1937 to 1941 the underground economy was small. Using that base period, he found that currency averaged $217 per $1,000 of demand deposits. Gutmann then determined that by 1976 currency in circulation had reached $344 per $1,000 of demand deposits (an increase of $127 per $1,000, or 36.9 percent). Gutmann therefore inferred that of the $77.8 billion in circulation in 1976, 36.9 percent, or $28.77 billion, was used to fund the underground economy. The other $49.1 billion of currency in circulation, plus the $226.2 billion of demand deposits, made up the total money supply in the regular, reported economy. The total money supply of $304 billion supported a GNP of $1,869 billion. Gutmann therefore concluded that the $28.7 billion was supporting an unreported economy of $176 billion.

Gutmann noted that currency held abroad, or used to store ill-gotten wealth, is not subtracted before estimating the unreported GNP. Furthermore, on the basis of the $176 billion generated in the underground economy, Gutmann estimated that up to 1.6 million more workers may have been employed than were reflected in official statistics. In a later study, he revised this estimate to 5 to 6 million workers who are employed only in the underground economy (10).

In 1978 Edgar L. Feige, an economist from the University of Wisconsin, estimated the underground economy at $400 billion (7, 8). Feige questioned Gutmann's assumptions relating to the base period chosen, an unchanging ratio of currency to demand deposits, the use of currency as the exclusive medium of exchange in the underground economy, and the same amount of GNP generated by reported and unreported dollars. Instead, Feige used the sum of all transactions to estimate total macroeconomic activity. The ratio of total transactions (using the estimated life of circulating currency) to observed income was determined. The ratio for the benchmark year, 1939, was used to estimate GNP without an underground economy. The difference between the estimated and actual GNP produced Feige's approximations of the underground economy.

As with Gutmann, some of Feige's assumptions are questionable: the choice of an appropriate base year, the assumed nonexistence of an underground economy in 1939, the relative income velocity in the irregular and regular economies, the estimates of turnover rates of demand deposits and currency, and the exclusion of barter transactions from the estimates.

Gutmann and Feige used entirely different methodologies, yet each estimated that the underground economy was growing two or three times faster than the regular economy. Both men revised their estimates in 1981, raising them to $420 billion and $800 billion, respectively. These estimates suggest that as much as 10 to 25 percent of GNP may be unreported.

Moreover, since these amounts are excluded from national income statistics, it is apparent that many of the widely followed macroeconomic measurements are erroneous, and the judgements based thereon may be misleading. Such measurements as national income, GNP, unemployment, and inflation are seriously misstated, because they do not take into consideration the underground economy. Yet many government and business decisions are based upon those numbers, including the automatic indexation of social security benefits, many wage contracts, changes in the money supply, and various social programs.

In 1979, the IRS published the results of a special study of 1976 incomes (14). The IRS estimated that individuals had failed to report approximately $135 billion of income in 1976. Of this, about $100 billion was income from legal sources, which should have produced some $17 billion of income tax. The report, quite appropriately, pointed out that during the same year individuals did report $1.73 trillion of income and paid $142 billion in taxes. Thus, it was estimated that in 1976, 92.6 percent of income from legal sources was reported. The IRS estimated the unreported amount of legal income from various sources as follows:

Individual Income 1976

(Dollar amounts are shown at the midpoint of ranges estimated by the IRS.)

	Billions of Dollars		Percent
	Reported	Unreported	Unreported
Salaries and wages	$ 881	$ 24	2.6%
Dividends and income from subchapter S corporations	25	3.5	12.3
Interest	49	6.5	11.7
Capital gains	19	4	17.4
Self-employment	60	36	37.5
Rents and royalties	6	4.5	42.9
Pensions, annuities, estates, and trust	27	5	15.6
Other	7	2.5	26.3
Totals	$1,074	$ 86	7.4%

This table indicates that in all categories other than salaries and wages, $193 billion was reported, but $62 billion, or 24.3 percent, was not reported. When this 24.3 percent unreported is compared to the 2.6 percent of salaries and wages unreported, it is easy to see the significant effect of withholding. As would be expected, some of the above estimates are more reliable than others. Jerome Kurtz, at that time commissioner of internal revenue, indicated to our task force that the interest and dividend figures were quite firm, whereas the self-employment estimate was rather soft.

These estimates were derived from several data sources. The Taxpayer Compliance Measurement Program (TCMP) provided information on the nature and extent of compliance, using stratified random sampling of returns filed. Discriminant analysis was employed to divide taxpayers into ten classes, each of which had a distinct compliance profile. Selected returns were examined for compliance, and data were weighted appropriately to obtain summary statistics. Data on nonfilers were obtained from the Exact Match File (23), which had been developed from interviews of 50,000 households. This program was directed toward nonfilers having substantial tax due, and thus did not include nonfiling taxpayers with smaller incomes. Other information from a file on employee compensation permitted estimation of the amount of nonfiler wage income. Total income received by individuals was compared with total income reported on tax returns using macroeconomic data from the Bureau of Economic Analysis.

In the previous table, no attempt was made to distinguish between underreporting and nonfiling because of the limitations of the data.

These sources provided only the beginning points for many of the estimates made in the study. As noted earlier, some types of information are more reliable than others. For example, information on income subject to withholding is of a higher quality than that on rents and royalties.

Some preliminary figures on the "Gross Tax Gap" were released in March 1982 as part of Commissioner Roscoe Egger's statement before the Senate Finance Committee's Subcommittee on Oversight of the Internal Revenue Service. These figures are included here to illustrate the growth in the underground economy. It should be noted that these 1982 figures report unpaid taxes, whereas the 1976 table reflects unreported income. The 1982 report covers income tax only and does not include social security or unemployment taxes, which would undoubtedly be large amounts. The 1982 study also covers the illegal sector for which the estimated tax gap was in the range of $6.1 billion to $9.8 billion in 1981.

Some reports issued during the fall of 1982 indicated that the earlier measures of the informal economy might have been substantially overstated. However, as stated before, we have not attempted to measure the magnitude of the underground economy nor do we endorse the methodologies or results of any of the studies. All of the studies indicate that this is a serious problem that needs prompt attention.

Gross Tax Gap From Individual Income Tax Returns Filed, Nonfilers, and Corporate Tax, Tax Years 1973, 1976, 1979, and 1981

	Amount of Tax Gap (Billions of Dollars)			
	1981	1979	1976	1973
Individual Tax				
Tax loss from underreported income:				
Wages	$ 2.5	$ 1.8	$ .7	$ .6
Tips	2.3	1.7	1.4	.9
Dividends	3.6	3.1	1.5	.9
Interest	4.1	2.9	1.3	.9
Capital gains	9.1	8.5	5.1	2.0
Nonfarm business	26.2	17.5	11.6	9.6
Farm business	1.4	1.7	1.7	1.5
Pensions	2.8	2.3	1.1	.7
Rents	1.5	1.2	.6	.4
Royalties	1.3	.8	.4	.1
Partnerships	5.5	3.1	2.5	1.5
Estates and trusts	.5	.4	.3	.2
Small business corporations	1.7	1.2	1.2	.4
State income tax refunds	.4	.3	.1	.1
Alimony	.1	*	*	*
Other	3.1	2.4	1.0	.6
	$66.1	$49.0	$30.6	$20.5
Tax loss from overstated deductions, and credits**	$12.3	$ 9.4	$ 6.2	$ 4.8
Nonfilers**	4.9	3.4	2.2	1.2
Total individual tax gap	$83.3	$61.8	$39.0	$26.5
Corporate Tax**	3.9	4.7	3.6	2.8
Total tax gap from legal sector	$87.2	$66.5	$42.6	$29.3

*Less than $100 million

**These are preliminary IRS figures and have not been reviewed by the Office of Tax Analysis.

Note: Details may not add to totals because of rounding.

THE NATURE OF UNDERGROUND INCOME

It is clear that some types of income are more easily understated or omitted from a tax return than others. Thus, the underground economy thrives on income not subject to withholding or to informational reporting. Currency transactions are easier to hide from the tax collector than business conducted with checks. Both currency and checks are more susceptible to underreporting than are credit card transactions. Barter transactions bypass all records—currency, checks, and credit cards—and are the most difficult to detect.

A barrage of articles in the popular media have identified a wide variety of underground activities, ranging from the very small to the very large, such as—

- Skimming, including businesses that simply fail to record some of their cash sales, cab drivers who leave a few fares off the trip sheet, and merchants who take home television sets and write them off as shoplifting.
- Tips that are pocketed tax-free.
- Domestic help paid in currency.
- Wage earners who moonlight in second jobs and are paid in currency.
- Building tradesmen or auto mechanics who do extra jobs on their own time.
- Professionals who exchange services.
- Business travelers who "pad" expense accounts and do not report reimbursements as income.

- Unemployed workers or social security retirees who do odd jobs for cash while drawing benefits.
- Taxable use of business property and other taxable perquisites of business executives.
- Income that is paid directly into a foreign bank account.
- Garage sales and flea markets.
- Arts and crafts sold by the maker.
- Exchanges of goods or services through one of the many barter clubs or barter exchanges that have sprung up in recent years.

A number of articles in the popular media reveal a lack of understanding of the tax law and the tax system. Some writers fail to distinguish tax avoidance from tax evasion. They appear to condemn all wealthy taxpayers and businesses who avail themselves of the tax incentives intended by Congress to encourage precisely those activities in which the businesses are engaged. A Washington Post article, (18) included as an underground activity any business incorporated in a Caribbean tax haven to avoid U.S. taxes. While such articles may be inappropriate and unfair, they may indicate a public perception that is nurturing the underground economy. The belief that big businesses and the wealthy are avoiding taxes may influence individuals to rationalize their own do-it-yourself tax loopholes.

Some of the underground activities listed previously can produce cash with little or no taxable income. For example, garage sales are often mentioned as part of the underground economy; however, the sale of furniture, clothing, and other household items seldom gives rise to a recognized gain. Other than relatively valuable items—such as jewelry, sterling silverware, antiques, or art objects—few personal assets are likely to be sold for a price in excess of their original cost. Even in underground sales where the transaction is of a taxable nature, the taxable income is not the full cash received but only the excess over the adjusted basis of the property sold. While the sale of certain items may result in taxable gain, the sale of others may result in nondeductible losses. This generates a perception of unfairness that may cause some gains to go unreported.

Another segment of the underground economy that may not generate much taxable income includes part-time work and work for very low wages. The allowable exemptions and the standard deduction have increased the tax threshold to a point where much of the income from part-time student help, domestic workers, migrant workers and other farm employees, and many tips would not create a tax liability. The underreporting of such income is not to be condoned, but its importance must be viewed in perspective to the total underground economy. This is not to suggest that all small amounts be ignored. Small amounts on many returns can add up to significant revenue losses for the government.

Bartering

Bartering presents especially troublesome enforcement problems and may be one of the most rapidly growing areas in the underground economy. It covers a wide range of transactions—from neighbors exchanging baby-sitting or other favors, to doctors and dentists trading their professional services, to airlines exchanging otherwise unused spaces on planes for otherwise unused rooms in hotel chains. A relatively new phenomenon, the barter exchange allows individuals or corporations to provide merchandise or render services in exchange for bookkeeping credits. Those credits can be used at a later time to obtain any of a wide variety of goods or services advertised in the barter exchange catalog.

Bartering presents economic and accounting issues, as well as income tax problems. There are unresolved questions about the definition of income and about timing and valuation. Services exchanged among family, friends, and neighbors are probably gifts and therefore not subject to tax. In a direct exchange, the timing is certain although the valuation may not be. The Internal Revenue Code stipulates that income received in a form other than cash is to be reported at fair market value. But, this is often difficult to apply. What is the fair market value of a large block of otherwise unused space on several hundred airline flights? In a direct exchange between two parties, the valuation problem is often somewhat alleviated because value may be more readily apparent on one side of the transaction than on the other. However, the organized barter exchanges may exacerbate the valuation problem by postponing one side of the transaction.

Transactions through a third-party barter exchange also give rise to some technical timing problems. The basic question is whether gain should be recognized for tax purposes when credits are received from the barter exchange or at some later date when actual goods or services are received for those credits. An accrual-basis taxpayer would report income at the time the services are rendered or the merchandise delivered. A cash-basis taxpayer, on the other hand, might reasonably expect to report income when goods or services are received. It is not certain that barter credits will ever be exchanged for goods or services, and typically there is no provision for refund for unused credits. Nevertheless, the IRS has ruled that barter exchange transactions are taxable at fair market value at the time that goods or services are rendered in exchange for credits (19).

POSSIBLE CAUSES OF UNDERREPORTING

By definition, the underground economy is susceptible neither to precise measurement nor to definitive analysis. Although it is difficult to discern exactly why more and more people are participating in the underground economy, several contributing factors can be identified.

1. The combination of high tax rates and high inflation can cause taxpayers to find themselves with a lower real income, yet a higher tax bill. Otherwise law-abiding taxpayers may reason that their tax burden has risen above their "fair share."
2. The increasing complexity of the tax law can erode public confidence that the tax law is treating everyone fairly. The uneasy, perhaps even subconscious, feeling that others are escaping tax can be used as a rationalization for cutting a few corners.
3. Closely related to, and a substantial cause of, the complex tax law is the use of the Internal Revenue Code to motivate or impede certain social and economic activities. What Congress intends as a tax incentive may be perceived as a tax loophole by some who are not in a position to utilize that particular provision. The perception that Congress is intentionally allowing wealthy taxpayers and big business to escape taxes legally can be a strong motivation for others to create their own tax savings.

4. The increasing media attention to this problem may turn into a self-fulfilling prophecy. It becomes easier to rationalize tax cheating on the grounds that "everyone else is doing it."
5. The changes in social mores and general morality that have been evident in many walks of life also have had an impact in the tax arena. Many people seem to have less confidence in, and respect for, many of society's institutions, including government, the church, universities, big business, and big labor. There is a growing feeling that it is acceptable to ignore "unfair" laws.
6. There is a growing perception that the IRS enforcement practices are applied in an uneven and inequitable fashion, whereby low- and middle-income taxpayers are harassed over small amounts, while insufficient attention is paid to the wealthy and especially to nonfilers.
7. Increasing government rules and regulations and payroll taxes provide motivation for many businesses to keep employees off the books.
8. A perception—whether correct or not—of widespread waste and inefficiencies in government is often used by some to justify their underreporting.
9. There may well be a lack of understanding on the part of many taxpayers as to —
    - The fact that underground types of income are taxable.
    - The risk involved in the failure to report fully.
    - The serious impact the underground economy can have upon society in general.

EXPERIENCE ABROAD

The underground economy is not a phenomenon exclusive to the United States. It seems to thrive in many, perhaps all countries, regardless of their political or economic systems.

The largest underground economy is believed to be Italy's l'economia submersa, which has been estimated at 30 to 35 percent of the regular economy, or $43 billion (3). Feige states that the underground economy is smaller in Scandinavian countries, where there is a "social contract" between the government and the citizens, than in Italy, where "respect for authority has been crumbling for centuries" (7). Nevertheless, Sweden is estimated to have a secret economy equal to 10 percent of the national product and a loss of tax revenue equal to 15 percent of the budget (3).

France's travail au noir, may constitute 25 percent of the official economy. West Germany's Schwarzarbeit may equal $25 billion in untaxed labor income and $4 billion in lost tax revenues, in addition to uncollected payroll taxes. Britain's fiddling was estimated to be 7 to 8 percent of the national output in 1979, but may now be as much as 15 percent. Less than 10 percent of Thailand's 19 million workers file tax returns, and up to 40 percent of all Argentine business is involved with morocho, or the black money market (3, 17). These statistics indicate that the underground economies abroad are at least as large as in the United States. The problem in Europe has been deemed serious enough for the Organization for Economic Cooperation and Development (OECD) to authorize a study of the legal and administrative provisions pertaining to tax avoidance and evasion in member countries (16).

The reasons given for emergence of sizeable underground movements abroad include —

- High tax rates or steeply progressive tax schedules.
- The combination of high tax rates, budget deficits, and inflationary pressures.
- The high percentage of cash transactions. (One half of Britain's labor force is paid in cash.)
- The large percentage of workers in agriculture, an activity that traditionally has been kept off the books. (Extensive moonlighting has been a tradition in France.)
- Deep distrust of government.
- Government inefficiency.
- High labor costs, which encourage firms to keep employees off the books to avoid payroll and unemployment taxes.
- Honest businessmen's feelings that they must join the underground in order to remain competitive.

The number of workers engaged in moonlighting and regular jobs kept off the books continues to expand as individuals and firms struggle to meet inflated costs of living and business expenses. Perhaps 5 percent of Europe's labor force and one third of Italy's (65 percent of the government employees and teachers) are involved in secret employment (3, 22). Because of the minimal and inconspicuous capital requirements, many home and personal services are provided by moonlighters. It is estimated that one out of eight Britons earns as much as $2,200 per year from moonlighting, yet efforts to control moonlighting have been unsuccessful in Britain. The same problem has been observed in Belgium, France, and elsewhere.

Even if income is stated accurately, expenses may be overstated or even fictitious. Sales-type levies are often evaded, particularly the value-added taxes, which are "easy to evade, despite myths to the contrary" (17).

Perquisites are considered to be part of the "black economy" in Britain, where consultants may be paid in claret, and a large percentage of the automobiles are owned by firms and valued at only one third of what an independent appraisal would suggest for purposes of imputing income (6). "Friendship prices" and under-the-table exchanges flourish from Thailand to France, as well as in Britain. In Japan, "backdoor admission fees" are paid to universities, and entertainment establishments increasingly evade taxes. In the USSR, the second economy is composed of private producers who must pay bribes to facilitate production of goods and services unavailable from the state (9, 21). The diamond industry successfully evades taxes at all levels of production in many countries (2).

Control measures are largely unsuccessful, but France has launched a publicity drive against unlicensed house painters and artisans. Britain has tried to fine construction firms using unregistered workers, but fines have not successfully curbed this practice (3). It has been suggested that less government supervision and involvement are desirable, that self-policing through VAT and household deductions for repairs (against imputed income of owner-occupancy) be used, that as much activity as possible be legalized, and that business and employment costs be kept as low as possible (2, 15). Tax treaties should be designed to curb transfers between countries that might result in evasion of tax.

PUBLIC OPINION

There have been several interesting studies of public opinion about the underground economy and tax cheating in general. A Roper study (20) found that a belief that tax cheating is widespread is a stronger motivation for people to engage in bartering than is a belief that taxes are too high. A study conducted for the IRS by CSR, Inc. (4) found that only 13 to 14 percent of the respondents report having interacted with the underground economy, and no more than 17 percent agree with statements that tax cheating is acceptable. However, 27 percent admitted to being less than completely honest, and 9.1 percent stretched the truth a little in filing their 1978 tax returns.

In ranking the relative severity of various crimes, only 58 percent thought that stealing $500 from the government in taxes was "very serious," compared to 71 percent who thought it a very serious crime to steal $500 in cash from an employer, 69 percent who would not illegally obtain $500 in food stamps or welfare payments, and 62 percent who would not countenance stealing $500 from a giant corporation (4).

In Britain, only 31 percent of those questioned thought it was wrong to avoid tax on income earned in one's spare time (17). A Westat, Inc., study (5) found that noncompliance in the United States is also greater on secondary sources of income. Dollars withheld from the principal salary are considered to be the government's share, while dollars received from a second job or from a hobby in which the taxpayer invests time, material, and labor are regarded by many as nontaxable.

WAYS TO ALLEVIATE THE GROWING PROBLEM

While the underground economy is not susceptible to close scrutiny and detailed analysis, several things can be done to help alleviate the situation. It does seem clear that there is no single "quick fix." It is also unlikely that any two or three minor adjustments will make significant inroads on the problem. Real progress will require the coordinated efforts of Congress, the IRS, and other government agencies, and perhaps a major assist from the private sector. Attempts to educate the general public and reduce its willingness to participate in the underground economy will be more effective if they are initiated and conducted by nongovernmental groups.

Two general strategies have been suggested from time to time as possible solutions. Some say that more and better enforcement by the IRS is all that is needed. Others suggest that simply lowering the tax rates will substantially mitigate the problem. While both may be helpful, it is doubtful that either is a panacea.

Although the consensus both here and abroad is that high tax rates are a major contributing factor in the growth of the underground economy, it does not necessarily follow that reducing tax rates will cause the problem to disappear. Individuals who were motivated to find creative ways to avoid 70 percent tax rates may well continue those activities to avoid 50 percent tax rates. The underground economy seems to thrive in most countries around the world, regardless of whether their tax rates are higher or lower than ours.

Enforcement Activities

The IRS has estimated that a revenue agent can produce as much as $20 for every $1 of cost. More and better enforcement is, undoubtedly, needed and desirable. However, no one knows or can predict the level of enforcement that would be necessary to change the underground situation appreciably; and even if it were known, it is not certain that the IRS could attract enough good professionals to reach that level of enforcement, given the existing shortage of such individuals. Given the trend toward earlier retirement ages, the IRS should consider recently retired CPAs and other business executives as a new source of qualified personnel. However, it is important to consider what level of government surveillance and investigation the American society is willing to accept. At what point might the cure become more oppressive than the disease?

The IRS can improve its effectiveness by reallocating some of its present enforcement personnel and efforts. Many tax practitioners around the country feel that too much time and effort are being devoted to unproductive trivia when they could be applied to the underground economy. Even with improved efficiency, however, it seems apparent that the IRS will need additional personnel if it is to have much impact on the underground economy.

As one step, Congress should authorize additional resources for the IRS with the mandate that these resources be used on the underground economy. While the mood of the country today seems to favor smaller federal budgets and less government interference, it is likely that the large majority of citizens who are filing properly would welcome increased surveillance of those who are underreporting. Although reduced federal spending may be generally desirable, an increase in the IRS's budget will normally produce a reduction in the federal deficit.

Penalties

The Economic Recovery Tax Act of 1981 increases the penalties for failure to file informational returns from $1 per return and a $1,000 maximum to $10 per return and a $25,000 maximum. This is an important step in the right direction, but we also recommend the following changes in penalties. For more than twenty years, the maximum penalty for criminal fraud has been $10,000 per count. Whatever deterrent value this provision may originally have had has seriously eroded due to the declining value of the dollar. The $10,000 amount should at least be adjusted for inflation. The penalty for civil fraud should be changed from 50 percent of the total tax due to 100 percent of the tax due on the fraudulently treated items.

Many years ago, certain penalties were waived for individuals who voluntarily corrected prior underpayments. The state of Illinois proclaimed a two-week moratorium from December 28, 1981 through January 8, 1982 during which time criminal penalties were waived for taxpayers who voluntarily paid back taxes (1). Such payments were still subject to interest and civil penalties. It has been suggested that taxpayers who availed themselves of the Illinois moratorium may have created problems for themselves at the federal level. The Treasury Department should consider cooperating with states in a program to encourage voluntary "catching up." It might be more effective to waive both criminal and civil penalties in such cases, but it does seem reasonable that interest continue to be charged. To the extent that the government already waives penalties in instances of voluntary disclosures, this policy should be publicized.

Informational Reporting

History has shown that the level of compliance improves when the individual knows that the IRS has, or will have, information about the transaction or activity. The IRS receives information from a variety of sources, including the various Form 1099s; informational schedules on tax returns, such as the partnership and the subchapter S schedule Ks; and answers to questions on the many types of tax returns.

Presently, anyone in a trade or business is required to file a Form 1099NEC for certain types of payments in excess of $600, but only if those payments are made to individuals. Such reporting should be extended to include payments made by businesses to corporations, since many individuals and other small businesses have incorporated in recent years. If this produces an unwieldy flood of paper to the IRS or an unreasonable burden on the business community, a higher threshold might be adopted. For some time, copies of all 1099s have been supplied to the government but not necessarily to the recipient of the payment. ERTA now requires copies to be supplied to the recipient as well, as is presently required for 1099s filed for interest and dividend payments. If the taxpayer is aware that a Form 1099 has been filed, he is more likely to declare the payment as taxable income.

It is impractical and unreasonable to require taxpayers to attach copies of all 1099s to the tax return, as presently required for W-2 withholding statements and interest and dividend receipts that exceed a certain threshold. However, the $600-type payments usually are included in a gross income figure so that any matching by the IRS is virtually impossible. Requiring a list of such payments in excess of some reasonable threshold would be one possible means of facilitating such matching. At the very least, the total of all 1099s received should be reported as a separate item on the tax return.

California has adopted a requirement that anyone claiming a rent credit on the state income tax return must provide the name and address of the landlord. The federal government has a somewhat similar requirement for taxpayers claiming a credit for child or dependent care. This requirement should be extended to include other credits, such as the energy credit, for payments above a reasonable threshold.

The Federal Reserve Board requires that banks report certain large deposits or withdrawals of cash, but it is our understanding that this requirement is generally ignored. The tax authorities should either initiate their own reporting requirement or prevail upon the Federal Reserve Board to enforce the current requirement more vigorously. All businesses should be required to report cash transactions in excess of some reasonable threshold, such as $3,000 or $5,000.

States should be required to provide the federal government and the taxpayer with an informational 1099 on refunds of state taxes.

A system should be devised for reporting by the organized bartering exchanges. They might be required to report all of the credits issued to their members, or to report all transactions above a certain threshold. Similarly, some of the typically cash businesses such as auction houses, art galleries, and dealers in collectibles and rare metals might be required to report cash transactions above a reasonable threshold.

Several factors of informational reporting must be considered. The benefits are both real and psychological; real in the sense that the matching process can reveal the underreporting of income, and psychological in the sense that the taxpayer who knows that an item has been reported to the IRS is more likely to include it on the 1040. Both benefits are reduced, however, if the IRS does not have sufficient manpower to match and follow up on the information received.

Withholding

As indicated by the 1979 IRS study (14), the level of voluntary compliance is greatest when tax has been withheld at the source. That study also confirmed that the level of compliance is quite poor for self-employment income. An important portion of such income is earned by independent contractors. In 1979 the Executive Committee of the AICPA Tax Division "approved support of the concept of withholding tax from payments to independent contractors, subject to limitations and exemptions no less extensive than those recommended at that time by the Treasury Department" (Minutes, Federal Tax Division Executive Committee, July 17, 1979). This 1979 action was related to the question of differentiating and defining employees and independent contractors. However, such withholding could raise the level of tax reporting by independent contractors. In February 1982, the Federal Tax Division Executive Committee endorsed the concept of withholding on business payments to independent contractors, with two important caveats. It does not seem feasible to expect withholding by individual households; thus, this requirement would not apply to activities such as home repairs. Secondly, it must be recognized that a payment to an independent contractor becomes a part of gross income, whereas the eventual tax liability is computed on net income. Therefore, the withholding rate should be kept quite low—perhaps 3 to 5 percent. Even at a relatively low level, the withholding would be an important factor in assuring that the contractor will include the payment in reported income.

It has often been recommended that interest and dividend payments should be subject to withholding. If the level of compliance could be raised to that achieved on salaries and wages, the government would collect some $2 billion to $4 billion more in income taxes based on the 1979 IRS study (14). In addition to this increased revenue, such withholding might be an important factor in improving the image of equity in the tax law, since many wage earners feel that investors also should be subject to withholding.

Withholding on interest and dividends has been discussed extensively and has been considered seriously by Congress from time to time. Strong objections are raised—primarily on the grounds that it would be unfair to those who will not owe as much tax as is withheld. Furthermore, it is assumed that those individuals will be required to wait up to eighteen months to get a refund of the over-withheld tax. Some proposals attempt to overcome this problem by providing that low-income individuals and exempt organizations could file a statement with each company indicating that less tax should be withheld. This procedure would overcome the first objection, but would impose serious administrative burdens on both the payors and the payees. The payee would need to file a certificate with every payor—perhaps ten, twenty, or more corporations. New forms would have to be filed for every new investment, even for those that might be in place for a few weeks or a few days. Payors would be required to match these forms with the investors' names and to withhold at varying rates for different payees. Thus, we reject, as unreasonable and unworkable, any graduated withholding system for interest and dividends similar to the system presently in place for wages and salaries.

We do agree that in the interests of equity and maintaining the federal revenue, some form of withholding on interest and dividends is desirable. Innovative thinking is needed to find a system that can minimize the administrative burdens on both payor and payee and also minimize any economic hardship on the payees. It would be helpful if Congress and the major groups of payors and payees would work toward devising a viable system rather than simply objecting to any suggestion of withholding. We recommend that various approaches such as the following be studied and tested.

One system would shift almost all of the administrative burden to the IRS. A flat rate specified by Congress, perhaps 5 to 10 percent, would be withheld by every payor from all dividends and interest.

Eligible individuals and exempt organizations would need to file only one exemption certificate—with the IRS. The IRS would then refund the appropriate amounts on a quarterly basis. In essence, this would entail a deferral of 5 to 10 percent of interest and dividends for three to six months by those who would not owe the full 5 to 10 percent tax. After the initial deferral period, the level of income would be approximately the same as if there were no withholding. This would add a considerable burden to the administrative duties of the IRS, but it would be less than the total burden otherwise borne by the millions of payors and payees.

While the above suggestion should correct the major problems of a comprehensive graduated withholding system, it would create new problems, such as—

- The IRS would get a single exemption certificate from each payee but would have to match that with reports from payors in several different IRS regions. A quarterly refund may not be feasible.
- If the IRS did refund any excess withholding during the year, the investor would still receive a report from each payor at the end of the year indicating that tax had been withheld. All of this withheld tax would not yet have been refunded, and the taxpayer might be confused as to whether a credit should be claimed on the 1040 for some or all of the withholding.

If the flat rate withholding is held to a relatively low level—say 5 percent—refunds may be due to only a small proportion of investors. It might be reasonable to ask those investors to wait until the end of the year to get their refunds on the basis of the regular filing. This suggests at least two additional plans for consideration:

1. Withhold 5 percent from all dividends and all business interest payments and provide refunds at the end of the year to exempt organizations and to those payees who owe less than the 5 percent tax.
2. Allow exempt organizations to file exemption certificates with each payor who would then withhold the flat 5 percent from all other dividend and interest payments. Refunds would be at the end of the year.

In any system that provides for refunds after the end of the year, it might be feasible to require the government to pay interest from the end of the year in order to help alleviate any financial burden on the payees. A 5 percent flat-rate withholding should obviate one of the perceived administrative hardships. The taxpayers should not be required to attach withholding certificates. A listing of all interest and dividends should be sufficient.

If a viable system cannot be found to substantially reduce the administrative costs to the payors, another approach might be to allow the payors a tax credit to offset some or all of those costs.

If an acceptable comprehensive withholding system cannot be found, the IRS might identify particularly troublesome situations and impose withholding only in those areas. For example, if compliance is especially poor on taxable coupon bonds, income tax could be withheld from those interest payments. Institutions presently apply withholding on a selective basis (such as on nonresident aliens) and should be able to apply it to specific types of bond issues.

In February 1982, the Executive Committee of the AICPA Federal Tax Division endorsed the concept of withholding at the source of interest and dividend payments provided that either the administrative burden be shifted to the government or the cost of such withholding be borne by the government.

Tips are another source of income that is seriously underreported. The IRS estimates that only about 16 percent of tip income is reported. The IRS has made many studies and has estimated the normal percentage of tip income in various types of establishments. These estimates have been accepted and upheld by the courts in several cases. However, even with these successful efforts, it seems clear that the usual enforcement techniques are not likely to be economically viable due to the large number of individuals involved and the relatively low amount of tax per individual.

Various approaches used in the past have not been effective from an enforcement point of view. Other methods that have been proposed from time to time have been subjected to severe criticism from the businesses and the employees who would be affected. If the various interested parties could be brought together to explore some innovative ideas, perhaps a mutually agreeable solution could be found. It would seem preferable for such a meeting to be sponsored by an organization that is not directly involved in the issue.

As an independent party, the AICPA Federal Taxation Division should invite representatives of the various industries and employee groups to come together to find an acceptable approach. These interested parties should come realizing that this is a serious problem for which a solution must be found. The group should explore any and all approaches to the problem. New and innovative ideas are needed. Two such ideas that should be explored are suggested here, but all parties should attempt to come up with as many others as possible.

> A low, flat rate tax could be collected from hotels, restaurants, airports, or other establishments where tips are common. The establishments could then be authorized to withhold or otherwise collect the appropriate amounts from the employees.
>
> The income of establishments could be grossed up to include the estimated tip income of the employees. A deduction would be allowed for the amounts reported as employee compensation. This approach also might incorporate a withholding mechanism.

The IRS 1982 study shows that the tax gap on pension income is growing much more rapidly than the total gap. This trend is likely to continue as larger numbers of taxpayers receive pensions from a larger number of plans. This is a confusing area for many taxpayers because social security is tax-free, and varying amounts of many other pensions represent tax-free return of capital, while many pensions are 100 percent taxable.

Presently, pensions are subject to informational reporting on Form 1099R. The pensioner may request withholding at the source. We recommend that all taxable pension payments be subject to a modest (say 10 percent) flat rate withholding tax with the pensioner having two options:

1. Withholding at a higher rate

2. Exemption from withholding if it can reasonably be expected that no tax will be due

Currency Reform

There is another long-range approach that we have not seen discussed anywhere else. Although it is removed from the tax arena, intuitively it would seem to be worthy of consideration as a possible deterrent to the underground economy. The vast majority of transactions in the underground economy, other than bartering, are conducted with cash. In the modern world of computers and other electronic devices, there have been suggestions from time to time that modern technology may eliminate the need for cash. Credit cards, electronic fund transfers, paying bills by telephone, and shopping via cable television have all been suggested as the "wave of the future." It might be worthwhile for the government to take steps to encourage those developments and hasten the day when we might need little or no currency in circulation.

An experiment along these lines that the government might try in the near future would be to withdraw from circulation all bills larger than the $50 bill. In a widespread but completely unscientific survey of people in the business community, we have found no evidence that any legitimate economic activity would be seriously disrupted if there were no $100 bills in circulation. Yet, the number of $100 bills in circulation has increased far more rapidly than any other denomination. If it can be presumed that most of these bills find their way into both the informal and the illegal segments of the underground economy, the absence of such currency could be a deterrent to those activities. If it is deemed necessary or desirable to have $100 bills in our currency system, an approach used in Switzerland might be used to produce some of the same benefits. Under the Swiss system the $100 bills, and perhaps the $50 bills, would expire periodically. Anyone holding such currency would be required to exchange it at a bank.

Miscellaneous suggestions

The following are additional suggestions that should be considered:

- States should be required to withhold from payments to lottery winners above a reasonable threshold.
- Tax deductions should be denied for cash payments (other than W-2 type wages) above a reasonable threshold.
- Reporting of capital expenditures, including additions to the basis of residential or other property, should be mandatory.
- Deduction for the cost of incentives or prizes should be denied if the value is not included in a Form 1099 (such as the prizes awarded to customers who open new accounts).
- Questions could be added to the individual 1040, Schedule C regarding any bartering or currency transactions.

Educational Programs

Some individuals may underreport income simply because they do not understand that the income should be reported. In addition, even those individuals who know they are underreporting may not understand all the potential consequences to themselves or to society.

Educational programs might be as effective as major increases in enforcement activities and would very likely be more acceptable to society.

The government should increase its education efforts. A concerted effort should be made to counter the negative publicity given the underground economy. More publicity should be given to the number of returns filed, the amount of tax paid, and the relatively high level of voluntary compliance. The IRS should better publicize its enforcement activities and the results thereof. Instructions for the various tax returns, as well as releases to the popular media, could be used to explain that bartering and currency transactions are to be reported. Special efforts could be directed at those groups more likely to be noncompliers.

It is highly unlikely, however, that government educational programs alone will be sufficient. Statements from the government are often considered to be self-serving and are viewed by many citizens with a great deal of skepticism. Any effort to modify society's views toward the tax system and toward responsibilities to society and to government would be far more effective if it were sponsored by groups outside the government. Such an effort would indeed be a major undertaking, requiring the resources of many groups, and it would be far more effective if it were a cooperative venture involving a wide variety of different types of organizations. For maximum exposure and impact, the program should be cosponsored by professional organizations, trade associations, labor groups, and civic organizations.

Such an educational program should utilize all media and should emphasize such points as—

- The present voluntary compliance system is valuable and should be preserved.
- The large majority of taxpayers do pay their tax.
- Most so-called loopholes are really incentives approved by Congress to improve our economic or social structures.
- The typical underground transactions are indeed taxable, should be reported, and are reported by most taxpayers.
- The possible consequences of participating in the underground economy include both personal risks and institutional consequences of excessive government enforcement.
- We cannot "cheat the government"; any underpayment simply adds to the burden of fellow citizens.

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Chairman PICKLE. Thank you, Mr. Hoffman.

I am sure we are going to proceed on this approach on the roundtable and get our colleagues together and see if we cannot make some improvement.

First, Mr. Skadden, did you want to make any additional statements?

All right, thank you.

I do not know if I understood, Mr. Hoffman, what you said about the $10,000 reporting requirement from banking institutions. Were you asking that we do away with that, or just reduce it?

Mr. HOFFMAN. No, I asked for it to be increased in range. And the way that we suggest that it might be considered to be increased is as follows: You have a $10,000 reporting requirement, banks that handle cash transactions of $10,000 or more are supposed to report it. That is good. But we believe that dealing in cash throughout the United States is a problem, and in large measure contributes to the tax gap, and probably also contributes to the illegal side of the tax gap that we have not measured here today.

So we suggest that there is no practical reason to have the $100 bill in circulation. It happens that the $100 bill has had the greatest growth proportionally to any other bill in circulation, as far as we understand it. We would suggest that you do away with it.

If you did away with it, all of those $100 bills would have to be brought in to the banks to have those exchanges take place and you would have an awful lot of $10,000 cash transactions being reported and we think that is all to the good.

Chairman PICKLE. All right, well, with respect to the $10,000 level, you are actually saying in certain cases, it should be increased. I personally think that our main difficulty in that area is that it is not being enforced. And I notice that the Attorney General in the last few days has actually commandeered funds in about 173 banks just because there are indications that they were not reporting, or at least they were receiving funds that might be classified as illegal.

I think that probably if we extend that requirement not just to banking institutions but require it of businesses—jewelry stores, boat companies, automobiles—I think that probably there are violations of the $10,000 reporting there.

But I would think that I would agree with you, in general, that there is an informational gap, more than just a tax gap, and I think that is probably a good point. And we ought to keep that in mind.

I will come back with some other questions, but I thank you.

Mr. HOFFMAN. Thank you, Mr. Chairman.

Chairman PICKLE. Now, I am going to ask Mr. Holden, if you would proceed, sir. Mr. Holden represents the American Bar Association.

STATEMENT OF JAMES P. HOLDEN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY THOMAS TROYER, VICE CHAIRMAN

Mr. HOLDEN. Thank you, Mr. Chairman.

My name is James P. Holden and I chair the Section of Taxation of the American Bar Association and I am accompanied, Mr. Chairman, by Thomas Troyer, the vice chair of the tax section.

On behalf of the 27,000 members of the tax section and the 375,000 members of the American Bar Association, we are delighted at the invitation to testify on this subject of income tax compliance.

Mr. Chairman this is an area in which we have been very active. Over the past 7 years, we have sponsored two major invitational conferences and we have published three comprehensive reports on the subject of income tax compliance.

At our most recent conference in 1988, we were privileged to have Mr. Dorgan of the subcommittee as the keynote speaker. My testimony today is based largely on the results of the 1988 conference.

I would like to address three general areas within the context of the areas you have identified—problem areas, techniques for resolution of those problems, and finally encouraging taxpayer attitudes that are favorable to compliance.

Turning first to problem areas, we encounter the very difficult problem of self-employed persons and independent contractors. There seems to be a clear consensus, and the GAO figures and the IRS figures that were released today support this, that compliance by self-employed persons is at the low end of the scale. This effective exemption from taxation not only has a revenue effect, but it also has a very corrosive impact on the rest of society because the rest of society views this as a very unfair situation.

The corrosive effect in this area is also magnified by the fact that not only is the self-employed person guilty of tax evasion, but the customer who pays the self-employed person in cash is an unwitting conspirator in the tax evasion. A number of mechanisms have been suggested to increase compliance among the self-employed and several deserve your consideration.

I would like to emphasize that I am recommending here that they be studied, not suggesting that they are ready for immediate implementation. First, it would be possible to require nonbusiness individuals who pay in cash for goods and services above a designated amount to report those payments to the Internal Revenue Service, perhaps on their own tax returns, and our written testimony comments more fully on that point.

Second, more frequent and more intensive audits of self-employed taxpayers should be studied. In these audits, broader use of information reporting should be pursued. There are real complications in this area because of the legitimate use by business taxpayers of different tax years and different accounting methods. Nonetheless, the IRS is currently studying those problems and they should be capable of solution. The study is important and it should be pressed forward.

Third, small corporations, partnerships, and proprietorships could be required to file, in addition to their tax return, a financial statement. Mr. Schulze was talking this morning about the importance of financial statements of a small business. If there were a requirement that a small businessman reconcile his financial statement that he uses for banking and financial purposes with his tax return, there would be an additional incentive to full compliance.

The area of independent contractors specifically presents very difficult compliance problems. Historically it has been very difficult to distinguish those who are independent contractors from those who are employees. The old common law test of employment, which is control by the employer is too amorphous to serve as a touchstone in this area, and yet, very significant tax impacts result from that classification.

If the party performing services is an employee, withholding on wages occurs and employment taxes are paid through the usual system. On the other hand, if the individual performing services is an independent contractor there is no tax reporting unless the independent contractor decides to comply with the tax system, and there is no record of the transaction.

This area deserves special study. Noncompliance does, as the chairman has already indicated this morning, cause competitive dislocations within industries, because those who treat their service providers as employees are unfairly disadvantaged against those who treat their service providers as independent contractors.

There may be a possibility to solve this problem through more information reporting, and perhaps even by requiring withholding in some independent contractor relationships. It does require serious study.

When we come to the area of large corporations, I think all of us are fairly clear that large, audited corporations do not engage in overtly dishonest behavior. Yet the audits of those corporations produce large sums of money. The Commissioner indicated a belief—and I share that belief—that most of that revenue arises because of the uncertainties in the tax law, the difficulties of allocation, the complexities of things like depreciation and minimum tax, and not from overt dishonesty. And yet, this has to remain a very highly targeted area for IRS enforcement activity.

Chairman PICKLE. Well, Mr. Holden, we are not making that accusation that there is dishonesty or criminal intent on the part of the corporations but there ought to be less uncertainty with that group than other taxpayers generally, would you not agree to that?

Mr. HOLDEN. There would be, Mr. Chairman, if the tax law were clearer in these particularly difficult areas. It is particularly difficult, for example, for a large corporation to determine whether income should be allocated between Great Britain and the United States, where the standard is the arms length standard. That is too amorphous a standard to be applied and naturally a corporation is going to seek to minimize tax expenditures. The IRS will come in and do an audit, and significant revenues may be produced from those audits. And they should continue.

We could improve the situation also by experimenting with ways of encouraging compliance. One of the innovations of 1982 was the adoption of the substantial understatement penalty, which contains as you know, an incentive to disclose to avoid the penalty. It would be well to study other incentives to compliance that could be built in, in the same kind of fashion.

I have already mentioned the section 482 international allocation problem and I will not dwell further on that. But until that problem is resolved, as we become more and more enmeshed in international trading and our trading partners improve their tax systems, this is going to be a very difficult compliance area.

When we look at the techniques for improving compliance, we have to say that withholding is at the very head of the list—nothing succeeds like withholding. On the other hand, information reporting is improving considerably, and it is much better than not having anything at all. So, as a second stage, information reporting is desirable.

IRS should continue to study the issue of information reporting within the corporate field, and it appears to be going forward with that study currently.

With respect to the issue of sanctions, one of the clear conclusions from our 1988 conference was the fact that the penalty system was drastically out of date and needed to be overhauled. And your subcommittee, Mr. Chairman, addressed that issue of penalties and addressed it very effectively this past year. We were very pleased to be able to participate in that effort and we are very, very pleased with the result that this subcommittee was able to achieve.

The problem of tax compliance relates largely to taxpayer attitudes, and this is a very important factor. The IRS continues to be the subject of some very serious adverse public perceptions, and that is a problem that it and we need to deal with. The source of many of those problems is inadequate levels of compensation within the Internal Revenue Service. Those are the folks that are dealing with the public and if they do not have the ability and the horsepower to do that effectively, then the perception problem will continue to exist.

The second aspect of taxpayers' attitude problems can be traced to the inadequacy of the computer architecture that is being used. It was designed in the 1950's, and implemented in the 1960's and it badly needs improvement so that taxpayer service can rise to an adequate level.

The taxpayer assistance program has been plagued by inadequacies. We understand that the Commissioner's most recent figures indicate an improvement in accuracy in this area, but too many answers continue to be wrong.

I would like to comment briefly on the issue of tax return preparers. In recent years, the so-called uncredentialed preparers—here I am not talking about the lawyers, the C.P.A.'s and those who are admitted to practice before the IRS. I am talking about the great army of people out there that prepare returns for taxpayers. We would have nowhere near the level of compliance that we enjoy today if it were not for the unenrolled preparer. That has become effectively a national resource, and yet, there is not any relationship that exists today between the Internal Revenue Service and that group of people. No special assistance is provided by the Service to preparers, and the Service is not aware of the manner in which they conduct their business operations. We feel that this is an area that ought to be examined.

The issue of IRS integrity is a matter of concern. As you know, a subcommittee of the Congress, Congressman Barnard's committee held hearings last summer and there were issues raised with respect to IRS integrity. To his credit, Commissioner Goldberg has used that as an opportunity to take constructive steps. He has made the internal inspection service more reliable, he has heightened the degree of external oversight of the IRS by bringing in the Treasury Inspector General, and he has created an external oversight panel which I have the privilege to chair.

I think that all of these things will tend to improve that integrity issue. The Internal Revenue Service must expect to be held to a higher standard than other large organizations, even though it has to deal with 120,000 employees.

Finally, Mr. Chairman, compliance is affected by the tax law, and the tax law, unfortunately is not as simple as we would like it to be. It has become fairer as a result of the 1986 act, but that issue of complexity is still there. We were privileged to sponsor a conference this past year with Mr. Hoffman's organization, the AICPA, on income tax complexity. It is a knotty problem but our organizations and the Congress and the administration need to continue to wrestle with it.

We very much appreciate the chance to present these views to you today. We are delighted with your suggestion that you create a task force, a task group in this area, and the American Bar Association will be very pleased to assist in that effort.

[The prepared statement follows:]

TESTIMONY OF JAMES P. HOLDEN
ON BEHALF OF THE SECTION ON TAXATION
AMERICAN BAR ASSOCIATION

Subcommittee on Oversight
of the
House Ways and Means Committee
April 19, 1990

Mr. Chairman and Members of the Subcommittee:

My name is James P. Holden. I chair the Taxation Section of the American Bar Association. I am testifying today on behalf of the American Bar Association at the request of L. Stanley Chauvin, Jr., President of the Association. On behalf of the 27,300 members of the Tax Section and the 375,000 members of the American Bar Association, I am pleased to appear before you to discuss the important subject of income tax compliance.

This is a subject on which the American Bar Association, through the Tax Section, has been very active. In 1983, we sponsored the First Invitational Conference on Income Tax Compliance at Reston, Virginia. Government officials, tax professionals, and academic analysts participated in the Conference. The proceedings of the Conference were published later that year in a 500-page report.

The work initiated by the Reston Conference was carried forward by the American Bar Association Commission on Taxpayer Compliance, which issued its report and recommendations in 1987. They were followed in 1988 by the Second Invitational Conference on Income Tax Compliance in Arlington, Virginia. We had the good fortune to have Congressman Dorgan, of this Subcommittee -- who has long given wise and persistent attention to the subject of compliance -- keynote the Arlington Conference. The Conference reviewed the 1987 report and recommendations and added further insights on the improvement of compliance. My testimony today is based largely on the conclusions reached at the Arlington Conference.

I. OVERVIEW

As this Subcommittee knows well, the subject of tax compliance involves a multitude of problems, issues, and approaches. I think that I can contribute best to your consideration of it by dividing my comments into three parts. I would like, first, to point up several important problem areas, well worth further exploration by the Subcommittee. I would like then to comment briefly on several techniques for improvement of taxpayer compliance. Finally, I would like to turn to the critical topic of encouraging taxpayer attitudes most conducive to securing a maximum level of compliance.

II. PROBLEM AREAS

Several areas present special compliance concerns. They include concerns centering on self-employed persons and, in particular, independent contractors; large corporations; and intercompany pricing governed by section 482. This list is far from exhaustive, but these problems are both quite significant in themselves and indicative of considerations which emerge in other aspects of tax compliance. Each warrants explanation.

A. Self-Employed Persons and Independent Contractors

While there is disagreement about the extent of the "tax gap," there seems a clear consensus that compliance rates among the self-employed (including shareholder-employees of small corporations) are at the low end of the scale. At the time of our Arlington Conference, for example, then-current IRS estimates suggested that less than half of the tax owed by self-employed persons was being paid voluntarily. Among the self-employed, independent contractors present special problems, warranting separate attention.

The effective exemption from taxation of much income earned by the self-employed doubtless generates serious annual revenue losses. It also generates a perception among the rest of the taxpaying public -- very generally subject to withholding -- that the tax system does not function fairly. That perception may incline honest taxpayers to look for opportunities for noncompliance themselves. This corrosive effect is magnified by the fact that noncompliance by self-employed persons often involves not only the self-employed person, but also the customer who cooperates by paying for goods or services in cash rather than in a traceable form.

The principal difficulty in devising effective measures in this area is that they tend to be intrusive and thus not politically acceptable or socially desirable. Conceivably, aggressive efforts to control noncompliance here could increase hostility toward the income tax system, thus compounding rather than reducing the overall compliance problem. Nonetheless, compliance levels among the self-employed are far too low, and raising them should constitute a high priority in enforcement.

A number of mechanisms have been suggested to increase compliance among the self-employed. Several deserve your consideration. I emphasize that I am here recommending only their study, not their adoption.

1. Information reporting by nonbusiness consumers of goods and services. It would be possible to require nonbusiness individuals who pay in cash for goods and services above a designated amount to report those payments to the IRS, perhaps on their own returns. The objectives would be both to track the cash economy more closely and to provide ordinary consumers with a reason to object to requests for payment in cash. Individuals making such reports might receive a modest credit to compensate them for the effort involved. While this procedure was discussed at the Arlington Conference, many participants thought it not feasible. As I have said, I here recommend only its further study.

2. More frequent and more intensive audit of self-employed taxpayers. If taxpayers in this category were audited more frequently and with better targeted audit objectives, the result would likely be an improvement in the general compliance level of the group as a whole. To enhance the effectiveness of these audits, the IRS should make extensive and creative use of its existing data base to identify the most frequent areas of noncompliance in the self-employment community. It should also consult with persons closely familiar with the particular businesses in each area to discover the specific points at which, as a practical matter, abuse commonly occurs. These areas and specific pressure points, once identified and assigned to carefully trained revenue agents, should produce both substantial revenue and higher general compliance.

In these audits, better and broader use of document matching techniques should receive serious consideration. In the past, the IRS has been reluctant to extend document matching to business taxpayers because of very real complications that arise from the legitimate use by such taxpayers of differing taxable years and accounting methods. Nonetheless, the IRS is now studying the feasibility of extending document matching to this area. The study is an important one, and it should be pressed forward. If the technique can be employed here, it should enhance compliance significantly.

3. Requirement of financial statement. Taxpayers in small corporations, partnerships, and proprietorships could be required to file, in addition to their tax returns, financial statements reflecting their assets and liabilities. The resulting necessity to reconcile the financial statement with the tax return would provide an additional incentive to accurate self-assessment of the correct tax liability. While a taxpayer inclined to omit income on a tax return might be thought equally likely to falsify a financial statement, financial statements are significant in credit arrangements and many other business contexts. Most business owners will be reluctant to have false financial statements in circulation and may well, therefore, be influenced to prepare their tax returns more accurately.

B. Independent Contractors

As an historical matter, it has been difficult to distinguish between those providers of services who are "employees" and those who are "independent contractors." In the real world of business, the kinds and varieties of business relationships are so varied and so vast that the old common law test of employment, supervision and control by the employer, is too amorphous to be uniformly and fairly applied. Consequently, many taxpayer/IRS disputes occurred in this area until Congress in 1978 created a statutory rule under which the employer/consumer's classification, if both historical and consistent, will not be disturbed.

Significant tax impact follows from the independent contractor/employee distinction. If the party performing services is an employee, withholding on wages occurs, and both employer and employee pay employment taxes through the usual system. On the other hand, if the person performing the services is an independent contractor, withholding disappears, and all tax liability associated with the transaction depends upon the filing of a return and self-assessment of tax by the service provider. If the service provider is not inclined toward tax compliance, there is substantial risk that the proper tax will not be paid. The 1978 statutory amnesty provided by Congress does not solve the problem. Indeed, it simply facilitates avoidance by those taxpayers who are so disposed.

This area deserves special study. Noncompliance is a very large problem here. Beyond its direct impact on revenue, intra-industry disparities -- where some businesses have *de facto* tax exemption as "independent contractors" and others in direct competition with them have no such advantage -- bring an added dimension of unfairness to the present situation. In some fashion, the playing field must be made more nearly level so that the present very strong tax inducements to independent contractor status are diminished. That result could be achieved, for example, by better information reporting or by requiring withholding in some relationships that occur in a business setting. Even the extreme solution of eliminating the independent contractor/employee distinction altogether should be examined. Tax compliance in the self-employed area cannot advance far without addressing this problem.

C. Noncompliance and Large Corporations

Large corporate taxpayers seldom engage in tax conduct that is manifestly dishonest. Nonetheless, all large taxpayers are audited for all taxable years by the IRS, and those audits do produce a very significant volume of revenue. The reason doubtless lies partly in the sheer size of the larger corporations, where even a small percentage change to a very large tax liability can result in large revenue yields. Two other reasons are, however, often also at work. The continued presence of revenue agents on the taxpayer's premises probably contributes to an atmosphere of negotiation that makes the original return position on a doubtful item seem less significant than the negotiated outcome; and the common lack of precision of the relevant tax rules adds to this sense of negotiation.

Given the high revenue yields from these audits, it would be unwise for the IRS to reduce the current allocation of resources to the Coordinated Examination Program under which the audits are conducted. Nevertheless, IRS should seek means of inducing a high level of audit compliance among large corporations at the lowest possible expenditure of audit resources. One such inducement enacted in recent years is the substantial understatement penalty of section 6662, which may be avoided by timely and adequate disclosure to the IRS of the items which otherwise would trigger the penalty. It would be desirable to study the effect that the existence of this penalty and its disclosure option have had on the reporting practices of large corporations and their principal tax officials. Such a study might lead to other experiments with similar compliance-inducing mechanisms.

Another area that deserves serious consideration for large business taxpayers is better use of document matching. I have referred above to the problems of implementing matching when the taxpayers who are the subjects of the reports use taxable years other than the calendar year and accounting methods other than the cash method. These problems are very real, but in today's technological environment, it is difficult to believe that, if aggressively attacked, they could not be overcome. Focusing primarily on large corporate taxpayers, the present IRS study of expanded document matching appears to represent just such an effort. Exceptions may prove desirable for classes of large business that have demonstrated records of broad compliance -- for example, corporations that publish audited financial statements -- but, overall, more extensive document matching appears to have real promise here.

D. Inter-Company Pricing by Multinational Corporations

Within the corporate tax world very large tax issues often present compliance problems entwined with public policy considerations. An example is the transfer price area under section 482 of the Code. Under current law, taxpayers operating in both the United States and foreign countries are expected to allocate income earned among the relevant jurisdictions generally by use of the arm's length standard. Conceptually correct as it may be, this standard lacks sufficient precision to provide a single, clear price in many transactions. As a result, it has been supplemented by a series of regulations issued by the Treasury Department.

However, effective regulatory guidance is hampered by the lack of a very clear understanding or agreement, both within our own government and with the governments of other nations, about the proper objectives of international allocations. Other nations' taxing authorities find it difficult to accept the proposition that the objective of international allocation should be to allocate to the United States as much of the worldwide income as possible. Until a clear and principled set of objectives is settled upon, complemented by a workable allocation mechanism, this will remain a compliance problem area; and so long as taxpayer incentives are generally to allocate away from the United States and IRS incentives are the reverse, enforcement will be difficult without clear and precise rules. This special set of problems surely warrants further exploration by the Subcommittee.

III. TECHNIQUES FOR IMPROVING COMPLIANCE

I have touched only upon a small sample of the universe of tax compliance problem areas. The Subcommittee should consider methods of enhancing compliance in the considerable number of other problem areas.

A. Withholding

Withholding is far and away the single most effective means of securing income tax compliance. The Subcommittee should study the feasibility of extending it to areas in which it is not presently utilized. Withholding on interest and dividends has, I need hardly say, been highly controversial whenever it has been raised. Without entering that controversy myself, I strongly suggest that the Subcommittee look carefully for aspects of the income tax system to which withholding can feasibly be extended. Wherever Congress adopts a workable expansion of the withholding technique, it will have advanced the cause of tax compliance significantly.

B. Information Reporting

In my discussion of possible mechanisms for coping with noncompliance by the self-employed in general and independent contractors in particular, I suggested study of expanded information reporting. It may well be useful to extend information reporting to other problem areas as well. While this technique is not as effective as withholding, it is far more effective than nothing; and its effectiveness will be considerably improved by modernization of the IRS computer technology. As one considers increasing information reporting, one must always bear in mind the necessity of balancing the production of useful new information for the IRS against the concomitant greater burdens on taxpayers. Nonetheless, careful review of specific compliance problem areas may well disclose those in which the scales tip in favor of expanded information reporting.

C. State Experience

As the states have themselves had to deal with increasingly tight budgets, they have developed a variety of measures not now in use at the federal level for augmenting income tax compliance. Massachusetts, for example, makes broader use of information reporting than does the federal government, extending it to such areas as reporting of rent payments by lessees. We ought to learn from state experimentation. The Subcommittee might well carry forward its work on compliance by devoting one hearing entirely to testimony by invited tax officials from the states which appear to be farthest advanced in devising successful techniques not yet utilized by the IRS.

D. Sanctions

One of the clear conclusions of the Arlington Conference was that the civil penalty system required rationalization and simplification if it was to be effective in encouraging compliance. I am happy to note that Congress achieved this objective in 1989 with an excellent legislative revision of the penalty structure. The achievement was due in no small measure to your work, Mr. Chairman, and that of this Subcommittee. We are pleased that we had the opportunity to testify before you and to work with your staff in that effort.

IV. ENCOURAGING HELPFUL TAXPAYER ATTITUDES

In an important sense, the entire problem of tax compliance is a problem of taxpayer perceptions. A central lesson of the Arlington Conference was its recognition of the pressing need for greater attention to the public relations aspects of virtually all federal income tax activities -- not only of the IRS, but also of those who write the tax laws.

A. The Internal Revenue Service

Despite the commendably energetic efforts of former Commissioner Gibbs and Commissioner Goldberg, the Internal Revenue Service continues to be the object of some seriously adverse public perceptions. To become vividly aware of that point, one need only have watched last Friday's PBS Washington Week in Review program to see the IRS depicted by prominent reporters as a structure on the brink of collapse, a "toothless tiger" in the view of one reporter, and a "hungry tiger" waiting only to pounce upon unsuspecting taxpayers in the view of another. The presentation was exaggerated and misleading in many respects, but I regret to say that it was far from uncharacteristic of the perceptions which surface from time to time in the media and from the public. Steps must be taken soon to cope with the real problems which produce these negative views.

1. Critical Improvements in Infrastructure

The source of many difficulties is simply personnel compensation. Career IRS employees are compensated at severely low rates. That fact bears adversely on the courtesy and professionalism with which the IRS treats taxpayers throughout the range of its dealings with them (and, of course, on the quality of its audits). The IRS must, after all, compete for employees with private organizations requiring accounting, legal, and computer skills. While the problem of inadequate compensation is not unique to the IRS, its impact on tax administration is clearly quite harmful. Given the importance of tax administration to the financial health of the nation, ways must be found to raise IRS salaries to satisfactory levels.

Another facet of IRS funding is similarly important. At present, the IRS continues to use a computer systems architecture that was designed in the 1950s and built in the 1960s. Plainly, the technology is woefully out of date. That fact has negative effects throughout tax administration, but it is particularly unhelpful in IRS relations with the public. One of the complaints which we suspect Members of Congress hear most frequently from their constituents is that taxpayers get persistent computer-generated notices and warnings from the IRS despite increasingly frustrating efforts to explain to the IRS computers that they have made a mistake. The present technology has proved exceedingly difficult to convince. Public annoyance, frustration, and negative perceptions of the IRS are the inevitable consequence. The proposed fiscal 1991 budget proposes substantial funds to begin updating the IRS computer system. I recently testified before Chairman Roybal's Appropriations Subcommittee to urge the taking of that first step -- and the necessary additional steps in future years -- and I urge your support also on this vital point.

Prompt and effective action on these two bedrock problems -- adequate compensation for personnel and adequate funding for modern computers -- will provide powerful assistance to the proper functioning of the IRS overall and, far from incidentally, much improve the perceptions which the public has of the IRS.

2. Taxpayer Assistance

Assistance provided by IRS to individual taxpayers in the resolution of tax questions is a cornerstone of public relations. Yet this program has a history of inadequacies. It is difficult first for taxpayers to reach the assisters, and the assisters too often do not provide accurate advice. Recent IRS statistics show marked improvement in accuracy -- now reported to be 80 percent -- and the IRS is surely to be commended for that; but the fact remains that 20 percent of the answers continue to be wrong. We believe it plainly desirable to provide taxpayers with assistance in coping with the tax laws that are imposed on them. If so, then the program must receive the funding necessary to provide trained, effective personnel and to give them the technological support required to permit them to function at the desired level. One possibility would be for the government to contract with the private business community to operate the taxpayer assistance program; but the private sector itself has proved far from infallible in providing tax advice. In the last analysis, this Subcommittee -- and Congress generally -- should give attention to what level of accuracy is desirable for this vitally important program, and all parties involved should then press toward attaining that level.

3. Relations with Tax Return Preparers

In addition to servicing taxpayers themselves with tax assistance, the IRS needs to develop a relationship with and provide assistance to the many thousands of individual tax return preparers who provide front-line services to American taxpayers. This army of preparers has over recent years become essential to even modest levels of tax compliance, and they represent an important resource. Yet no effective network exists through which the IRS provides assistance to them or monitors the manner in which they carry on their business activities. Licensing by the IRS is worth serious consideration. If it is adopted, Congress must provide the IRS sufficient additional funds to carry on this extensive new activity carefully and thoroughly. In any event, the establishment of a systematic program of useful IRS/preparer relations should have high priority.

4. Education and Enforcement

Beyond assistance to taxpayers and preparers, IRS public education efforts are extremely important to tax compliance. The objectives should be not only to appeal to the social conscience of taxpayers but also to make them aware of the possibility of detection of noncompliance and the consequent risk of penalties. Indeed, the public awareness program should include the role of the criminal enforcement program and its possible application in appropriate cases. This kind of public education will, of course, have the desired favorable impact on compliance only if it is accompanied by the reality of IRS enforcement. Audits must be increased to a level such that the probability of audit is not so remote as to be negligible. Social scientists and tax administrators may differ on what is a desirable audit level, sufficiently high to be cognizable but not so high as to be unduly intrusive; but by any plausible standard, it is clear that today's audit levels, even when weighted to account for different classes of taxpayers, are too low. Here again the only satisfactory answer is substantially increased funding for the IRS.

5. IRS Integrity

Public attitudes are also shaped to a considerable degree by public perception of the level of integrity within the IRS, particularly at its higher levels. The IRS has been criticized on this score by entities of the Congress. Commissioner Goldberg has responded by taking constructive steps (1) to make internal review and inspection more reliable, (2) to heighten the degree of external oversight of IRS by the Treasury Department Inspector General and (3) to establish an independent review panel, which I chair. With 120,000 employees, the IRS must expect that a few lapses in judgment will occur, just as is the case in other large organizations. However, IRS must, by reason of its mission, expect to be held to a higher standard than that of large organizations generally. Therefore, it must continue the search for systems and controls that will protect it to the greatest extent possible from the consequences of human frailty.

B. The Tax Law

Finally -- and very importantly -- public perceptions are also shaped by the demands of the tax law itself, not only in terms of the fairness of the financial burden that it imposes, but also in terms of the level of frustration that taxpayers encounter in attempting to comply with it. The Tax Reform Act of 1986 greatly improved the fairness of the Federal income tax. However, little has been done to improve the frustration level.

Indeed, the trend has been sharply and harmfully in the opposite direction. The 1986 Act is only one of 153 laws that Congress has enacted over the past 15 years changing the tax rules with which the American public and its advisors must deal. The magnitude and velocity of annual changes of the tax law already place grave pressure on the ability and willingness of the public to comply with its tax obligations and the ability of the IRS to administer the tax system effectively.

The problem of complexity is a very real one, and one not easily solved. The ABA Tax Section recently sponsored, in conjunction with the AICPA, an Invitational Conference on Reduction of Income Tax Complexity, which was well attended by government officials, tax practitioners, and academics; and we will continue both to study the matter and to work with the Ways and Means Committee and staff on simplification legislation. More broadly, though, it is evident that the tax-writing committees, their staffs, and the Treasury Department should recognize the profound need to squeeze complexity from the present tax law so far as they can -- without in any way beginning to dismantle the vital substantive reforms of the 1986 Act. The committees must also strive, insofar as possible, to preserve stability and sharply to limit flux in our tax laws. Finally, as the committees consider new legislation, we urge that simplicity be made a primary objective and not merely a collateral consideration.

I very much appreciate the opportunity to appear before you today to present the views of the American Bar Association. We pledge our continued efforts toward the goal of higher levels of income tax compliance, and we look forward to working with you and your staff in that effort.

Chairman **Pickle**. Well, I appreciate your comments about the roundtable approach. I think the use of roundtables is a good approach and we will definitely proceed on it and see what we can work out there. And we will notify our chairman that we are going to proceed in this direction.

Mr. Holden, you just said that one of your problems is that we need to shape public attitudes about tax compliance. Do you have any suggestions about what we can do specifically about that?

Mr. **Holden**. Well, there are two areas, Mr. Chairman, I would focus on. One is the service that the Internal Revenue Service provides to taxpayers generally, because that interface is very important. When I testified before Chairman Roybal's committee in support of the IRS budget, he said, that the interface with the public is where the problems occur, and you have to improve that if the public perception is going to improve about the Internal Revenue Service.

And improvement turns on higher compensation, better people, and the improved computer architecture.

Now, with respect to the public generally and its attitude toward tax compliance, we think that the surface of this has just been scratched. At our compliance conference we talked about ways of having positive inducements to taxpayers with respect to income tax compliance. And behavioral scientists and others attended that conference and we would like to pursue that further, but we think that the message has to come across to the American people that it is in their interest, that it is this Government that these revenues support, and compliance is one of the ways of doing that.

Chairman **Pickle**. Yes, sir, we could make that point to the American people and I think that they would feel more accurately that they are paying taxes for somebody else. And they resent that and you cannot blame them.

And, yet, it is our Government and people ought not to take the attitude that they are going to try to avoid all taxes, but rather pay their just share. And it is a problem. It is a societal problem. And I think somehow we have got to change public opinion.

Now, Mr. Holden, you made one suggestion about tax preparers. I noticed that the BNA "Daily Tax Reports," today, reported that better regulations of professional tax preparers—I am quoting now—"may bring in an additional $15 billion each year, according to a study of professionally prepared tax returns."

Now, if we could bring in $15 billion that would be helpful. I would ask you, how do we get better tax preparers or how do we get this $15 billion, or maybe I ought to ask Mr. Hoffman that? Either one or both of you may answer.

Mr. **Holden**. I would be happy to comment first and then let Mr. Hoffman comment as well. But one of the problems that exists today is that anyone who wants to can hang out a shingle and say, I will prepare your tax return. And yet, we live with a tax law today that is the most complex that we have ever seen and it will probably exist that way for some time to come, not just with respect to big corporations, but the small business owner who has a pension plan and the small business owner who has depreciable property, the small business owner who faces the passive loss issue. They have very significant and very difficult problems.

And, yet, the Internal Revenue Service provides no special assistance to school those preparers in what they have to do. And it, in turn, sets no standards for those preparers.

It is clear to me that this is an area that deserves a good deal of attention and by applying that attention to this area, I think that we could achieve some of that tax saving.

Chairman PICKLE. Well, Mr. Hoffman, to what extent have tax preparers contributed to this $15 billion shortfall, if that is a fact?

Mr. HOFFMAN. Well, Mr. Chairman, I do not know that that is a fact. And I think that that was the speculation on the part of——

Chairman PICKLE. Well, I was quoting BNA now.

Mr. HOFFMAN. Yes, but the point is that the tax law is so complicated that if you take competent preparers—and in one instance there was a magazine article which described a test of preparers and they did not come up with the same numbers and some were closer to the mark than others.

Within the set of facts related to this hypothetical tax study, there were all sorts of complications in the law. Mr. Holden mentioned that we held a joint conference on reduction of tax complexity and in that conference, illustrations of the complexity attributable to the lowest income taxpayer on child care matters, and on earned income matters—these are areas where innumerable questions have to be asked to find out if you qualify. And these people are incapable of handling it and preparers are not necessarily capable of handling it, and that is where the IRS is making its mistakes on the telephone.

These areas of the law need simplification and you will get your preparers, assuming they are honest, you will get your preparers to prepare more accurate tax returns, if many of these areas that they have to cope with were more simple. And I believe that should be addressed.

I do not think that most of the errors that were described in calculating the $15 billion gap were deliberate errors. It was a matter of dealing with areas which requires such intense study in order to find a right answer, that nobody, particularly a layman, is prepared to do it.

Chairman PICKLE. Well, I do not think that we ought to accept BNA just as a fact. But I think that we would all agree that the better prepared tax preparer system that we have the more accuracy and, in turn, the more taxes we will probably collect. It could work in reverse, they could tell you how not to pay your taxes; how to avoid them. But apparently we could get more money if we have better tax preparers. Now, that will take time.

Mr. HOFFMAN. Oh, I totally agree with Mr. Holden that the IRS should reach out to this army, because there is indeed an army out there and they are not within the usual circulation of information.

Chairman PICKLE. All right.

Now, Mr. Portney, could you just comment to me—since you mentioned the subject about accounts receivable at the first part of your statement—what is the impact on taxpayer compliance if the Internal Revenue Service fails to collect the accounts receivable fund?

Mr. PORTNEY. Well, what I am about to say is really based on anecdotal evidence. But my general impression, based on what I have seen is, that when the Service fails to pursue a debt which is an existing valid debt, it is an assessed tax—we are not arguing as to whether who is right and who is wrong, we are saying the liability is there—when the Service does not pursue the collection of that, or sends out a notice and if the taxpayer does not respond, and the Service does not do anything about it, it raises questions in the mind of that taxpayer as to how effective the Service is with regard to other parts of its responsibility.

And here, I think the Service is not doing itself any good by clinging and endorsing and reinforcing its public image as the nation's largest law enforcement agency. Because if you are a law enforcement agency and you are the biggest and when it comes to going out and collecting your debts, you are not doing it, you are a paper tiger. And if you are a paper tiger when it comes to collecting assessed taxes then what can you be when it comes to other responsibilities?

Then you get the 1 percent or 0.92, actually, percent audit coverage which gets publicized and tends to reinforce that kind of view. And it seems to me that before you know it, the question in the minds of those taxpayers is why should I even bother?

Chairman **PICKLE**. I think I agree with you, Mr. Portney, and Internal Revenue said we had some $85 billion in accounts receivable but they hasten to add that some of that money was from people who were dead and gone and moved and they did not know where they were. And that knocked off $10 billion of that money. And another group was involved in either litigation or in bankruptcy or in some way or another that could be questioned. But even then, they said that there was an area of about $40 billion.

Now, if that is real money, that ought to be collected, and I agree with you that if it is not collected, and it is a legitimate assessment, then I think the system is hurt. We are not talking about a tax gap now, we are talking about money that has been ruled that it is owed to the Government.

So I hope that we can do something about that and I hope that we can improve that attitude.

Can you tell me, Mr. Portney, why does the Internal Revenue Service have such a low recovery rate?

Mr. **PORTNEY**. Well, I think it is pretty well agreed by many as to why the recovery rate is so low. I think it is a function of two things. One is that they do have a serious quality problem and I think it is for all of the reasons that people have acknowledged—the poor salary structure. I do think the training has been a problem. They seem to be getting close to a solution of going outside and acquiring the training.

I think the other is a function of the complexity. I think that they go hand-in-hand, the quality problem and the complexity problem. And I also think that the job of the revenue agent as the revenue agent sees that job is to raise revenue, raise issues and not to try to make any kind of objective determination of what the correct tax liability is.

And maybe that is simply a function of the way that the Service approaches its job, but that is what they do. And they propose deficiencies which, in the final analysis, are not based upon the necessary expertise that is available elsewhere, and the ultimate determination is that much of that proposed liability is simply not owed. And I think it is inescapable that some adjustments under the most qualitative circumstances are simply not going to be ultimately sustained, because when the Service looks at it and asks whether they are prepared to go to court with total confidence, the decision is that there are hazards to litigation. As a result, a settlement will be reached and I think that is a useful function of the tax system.

Chairman PICKLE. Mr. Hoffman, once more for me, explain to me how we would have better compliance if we did away with the $100 bill category designation?

Was that you who made that statement?

Mr. HOFFMAN. It was me that made that statement, Mr. Chairman.

We are talking about transactions that are more easy to establish for tax purposes. The transactions that are the most easy to establish and the transactions for which you have records are your credit card transactions, or payments by checks and so forth.

It is clear that at the end of the year, when you add up your checks, you know what you spent. It will not be so clear if you are spending it in cash.

And that applies to virtually every business in every form. If you are receiving it in cash as a matter of payment for your sales, clearly you can forget about cash in part. But you cannot very well forget about invoiced items, for which you have been paid by check, by designated parties.

Needless to say you cannot get rid of cash at the moment in toto, but it is clear that the cash transactions that are of most concern are those at the higher numbers and it is also clear that the $100 bills are being used for the purpose.

Now, somebody is accumulating them and they are in circulation, and they are increasing in circulation and we would like to get a handle on that. It is not a matter of punishing anybody, it is a matter of negotiating with two $50's instead of one $100 bill. It will be harder to operate in a cash economy that way, then if they had the $100 bills in circulation to pay for the car or to pay for whatever it is in cash.

Furthermore, when they go to the bank to exchange it, they have got a $10,000 cash requirement and it would seem to us that it is going to be an awful lot of $10,000 cash transactions that are going to be reported as a result of people coming in for the exchange.

The other thing is that during that period of time, drop the $10,000 to a lower figure, perhaps, to $5,000. Make it as inconvenient as hell to cash in the accumulation of $100 bills that have been made in the past.

Chairman PICKLE. I see that Commissioner Goldberg is still out in the audience and Mr. Goldberg, do you have any comment about the elimination of the $100 bill with respect to this compliance problem?

Mr. GOLDBERG. I have no comments on that suggestion, Mr. Chairman.

Mr. HOLDEN. Mr. Chairman?

Chairman PICKLE. Mr. Holden.

Mr. HOLDEN. I would like to point out, if I could, that at our compliance conference we discussed this and related mechanisms and I want to support Mr. Hoffman's point. Some of the suggestions made at the compliance conference were that you changed the currency from green to blue occasionally. The underground economy is largely a cash economy, and if a member of that economy has $1 million in greenbacks, and you change the currency to blue, he has either got to give it away or he has got to convert it to blue. And if he converts it to blue, he has got to enter the cash system some place, and that is the point at which you track it.

Chairman PICKLE. Well, let me ask this group as a panel now. What single factor has the greatest impact on compliance? Where is the one area that Congress could enter that would be the most helpful in establishing better taxpayer compliance?

Mr. Hoffman.

Mr. HOFFMAN. Well, I have two suggestions. One is from a legislative point of view and we talked about complexity enough and I think it is a very important point. I think it is clear that an awful lot of the gap relates to the complexity of the tax law, that is number 1.

But number 2, it seems to me that the Internal Revenue Service has to be respected as an agency that can do all of its necessary followups, that has matters under control, that is in the modern age in terms of dealing with its clients, the taxpayers, and that has to do with the TSM program. The modernization program has got to be implemented.

If the program were finalized, put to you for funding, and if there is a multiyear funding provided to them, they need; if they had the computer resources to deal with taxpayers, things would be a heck of a lot smoother.

If taxpayers did not have to call and wait for answers and if their accounts were up to date, if the uncollected accounts were solicited by computer notice, like any industry does, the gap would close. There is an inability at the present time to cope with the volume and certainly as the volume grows, there will be a terrible inability. The current system has 1950's technology and the TSM has got to be funded and it has got to get underway.

Chairman PICKLE. Do you all agree, or do you have other suggestions?

Mr. HOLDEN. I think, Mr. Chairman, that the biggest issues revolve around cash transactions. The approach to compliance has to be multifaceted. But if you said to me I can only do one thing, and what would that be? I think I would move into the area of information reporting, very heavily in the sole proprietor/independent contractor area, requiring more reporting of cash transactions to bring those into the system.

Chairman PICKLE. That is a good suggestion.

Mr. PORTNEY. Mr. Chairman, while I was listening to your question I think that you were pressing for the one thing if you could not do anything else, what would that be. I guess that I do not know how to do this, but if there were some way to come up with the flattest kind of tax at all that would not be ultimately so regressive as to be unacceptable—in other words, just eliminate the confusion, the recordkeeping and the detailed reporting and so forth, to get us down to a point where the only real concern in the system was on unreported income and nonfiling where the focus could be largely limited. Then I think that I would agree with Mr. Holden and Mr. Hoffman, that then what you would concentrate on is trying to get as much accounting of transactions as possible reflected in expanded information reporting to narrow that unreported income gap.

Chairman PICKLE. Well, now, Mr. Goldberg, let me ask you to come up forward and let me ask you a couple of questions.

I am glad you are still hanging around, Commissioner.

First I have asked these gentlemen what would be some of their recommendations, some specific things that we could do, if they had any suggestions. And one suggestion we heard was that one of the best things that we could do is for the Internal Revenue to be really an effective agency and to have computer modernization programs put into place. IRS computers are operating on 1950 level instead of 1990.

What is your comment about that suggestion?

Mr. GOLDBERG. I think Mr. Hoffman is right on the mark, Mr. Chairman.

Chairman PICKLE. He is what?

Mr. GOLDBERG. He is absolutely correct. I think that is the most important challenge facing us. I think the one area that I would add to the subjects these gentlemen have mentioned is you can have all of the machines in the world and you can have all of the law changes in the world, but it comes down to the people. And I think that we have got to pay our folks right and we have got to train them right.

And I think that is real important.

Chairman PICKLE. I think I would add one other aspect. Somehow we have got to strive to improve society's attitude about the privilege of paying taxes and the joy of it in some respects. And I think that is another factor of it.

Now, can you tell me what steps you are taking, the Internal Revenue Service, with respect to computer modernization programs? What will it take and how far are you along? What do you expect will happen in the immediate years ahead? What kind of a schedule do you have?

Mr. GOLDBERG. Yes, sir. We will be completing this year a comprehensive statement of our overall design and plan. And it is a multiyear effort and our cost estimates are in the range of about $6 billion to do the job and it is going to take 5 to 7 years to complete. And we have taken a number of steps as we go—electronic filing was so successful this year as a part of the modernization effort. We have changed certain of our computer systems effective this spring to resolve a lot of the inaccuracies and delays in the system and parts of the system will show a lot of benefit this year and next.

We need to enhance the capacity of our computer system. We are simply running out of the capacity to deal with a growing system. That is an important part of it. We need to get away from the paper, and away from the labor intensive kind of work so that we can get the information into the machines and out of the machines quickly so that taxpayers can get their questions answered by phone, resolve their account issues by phone, instead of through correspondence.

All of these gentlemen have talked about—I think Mr. Portney's point about we are not using our information as effectively as we should—I think Gerry is right on the mark.

And the problem is in order for somebody working in accounts receivable, he has got some of his information at one computer terminal, he or she, and they have got to walk across the room to another computer terminal to get the rest of the information they need and then they have got to go down to the State or local courthouse to get the rest of the information they need.

And that does not make any sense and it is a serious problem in the accounts receivable area.

Chairman PICKLE. I am asking you though, do we have the computers and the machinery on order?

Mr. GOLDBERG. We are in the contracting process for various pieces of it, Mr. Chairman.

Chairman PICKLE. Do you need money?

Mr. GOLDBERG. We need money.

Chairman PICKLE. How much money do you need for that?

Mr. GOLDBERG. $6 billion.

Chairman PICKLE. Have you asked for it?

Mr. GOLDBERG. We have asked for the 1991 piece of that. As was pointed out by Mr. Hoffman, the budget process only lets us ask for 1 year at a time. Mr. Hoffman's suggestion is we should ask for the whole enchilada. We need the $6 billion. You appropriate that money and we will get the job done.

Chairman PICKLE. I would suggest we embark on that program with more vigor. Years ago when I headed up the Social Security Subcommittee we had to also approach the fact that we had to modernize Social Security equipment. I do not know that they are completely modernized, but they have made great strides in putting on track the computerization programs it needed. You need to do the same thing down there, and unless you do it then you are going to operating on paperwork instead of computer work and that is just not the modern world today. So I would say that that is something we ought to do.

Now what do you think about the suggestions these gentlemen have made in the area of cash transactions or in the general area of information reporting, that we should have more information reporting? Do you agree with that?

Mr. GOLDBERG. Again, I think these folks are right on the mark. The hardest problem in terms of compliance, you look at sole proprietors that you talked about, small businesses, informal suppliers, a lot of that is the cash economy, and we need to find different ways to deal with it. The currency suggestions—I am not conversant with it so I cannot comment on it, but it is an idea that has been around that is worth thinking about.

Clearly there are other areas where information reporting may be of benefit, would be of benefit. Again, I think we need to be very sensitive to the burden that we are placing on the American public. I do not think we should ask for the information unless that information is going to have a demonstrable effect on improving compliance. But there are areas. I think we ought to look at some of those areas.

Again, we are all saying the same thing, I think, Mr. Chairman. I agree with every word every one of these folks said; the independent contractor, employee area, information reporting questions, classification questions. It is a lot of money and very important. I do not think any of us have a different agenda. I think the question is, do we have the will and the ability to get it done.

Mr. PORTNEY. Mr. Chairman, last week on, I think it was the evening of April 10—I don't know how many people watched it—Roseanne Barr, which I understand is now either the most watched television series or the second most watched television series devoted its entire program—and I do not know how many millions of people watched this—to, I think kind of ridiculing the whole tax-filing process. What she and her television husband portrayed using the traditional shoebox overloaded with all kinds of receipts in a disorderly, trying to get through to the IRS, coming down there and not being treated very well, I think that that one program probably had as much of a negative impact on a great number of people.

And it is unfortunate, but I think that the Service can work day in and day out for months, for even years, and then something like that gets turned around by the impact that a program like that has. I do not know how the others feel about it.

Chairman PICKLE. I would hope that we would have some of those kind of programs of a more positive nature, but I think time is on our side and we can do that. We are trying to put more emphasis on taxpayer services. I think we have dropped a little bit, Commissioner, from where we started because of funding. We are still driven by budget rather than what taxes an individual should pay. I think that is unfortunate.

I hope though you keep emphasizing taxpayer services. We have got to increase the audit level. I repeat again to you, we may have to actually put a minimum, a floor under which you cannot go because you just can't keep dropping back because of budget because everything else suffers when that happens.

Now I think overall that this hearing has been a good hearing. I hope that it has not been one just too negative because we are not trying to say, where have you fallen down. Overall I think the system is the greatest system in the world, our taxpayer system. But I think we have got to accept, and I believe you gentlemen would agree too, that when you have $100 billion tax gap right now, and when you have accounts receivable of $85 billion, that that is not acceptable. We have got to do better.

I would think personally the first thing we can do is try to improve the attitude of the public, try to make them understand that we are doing the best we can. I am hoping that the so-called task force or roundtable will help us pull this together.

Now, Mr. Commissioner, we are going to try to put together a commission. And these people who represent the bankers, lawyers, and C.P.A.'s and others made a significant contribution to us in the civil tax penalty area. We are going to broaden that committee to have a good cross-section. Perhaps we can have a group then come to a group decision and not just you, the IRS, issuing an order or a regulation or the complaining about one that you have issued, but see if we can do it together. I am hoping we can do that.

I am convinced that the average person really is willing to pay his fair share of tax. But I am afraid that an attitude is developing in the country that "how can we beat the system." Now that is a natural inclination of the individual. But he takes that in part from what he sees happening somewhere else. If we do not close the tax gap, and if we do not collect these receivables, then I think we leave ourselves open to the criticism within the system and that the system is going to be hurt.

I think the trend is going in the wrong direction now, perhaps because we do not have enough simplification or perhaps because the laws have become too complex. It is a combination of circumstances. Overall, I am convinced that we have a good system but we sure have got room for improvement.

Now working together, maybe we can do that. At least we ought to try it and I am going to concentrate on that committee and ask you gentlemen to help us and to participate with us and offer us suggestions. If any of you have got any specific recommendations to the commission, right now or at any other time, you can have at it.

I might also point out, Commissioner, that we are going to have additional hearings on this very subject, maybe two more this year on this very subject of tax compliance or the tax gap. So we will have a chance to look into this thing further.

We have held off on this hearing because we wanted to get the deadline of April 15 date passed and it has. I do not suppose you know yet how you will come out, but it would be of interest to all of us because it is a common problem for us.

I want to thank you. I do not have any other questions of you at this time except to say to you that we are going to be in touch with you as we proceed to try to find a better way to collect the money that is owed us and try to instill in the American people a better feeling that they ought to pay more taxes or at least pay what is due. So with that as a note, I think I will call this hearing.

Does anybody have any other additional statement to make?

[No response.]

Chairman Pickle. If not, we will call this committee to be completed. I want to thank each one of you. I want to thank you for your participation.

The subcommittee stands adjourned.

[Whereupon, at 1:17 p.m., the hearing was adjourned.]

[A submission for the record follows:]

The Hidden Economy: Americans Beat the System

James Philpot, Financial Advisor*
Arkansas Department of Finance and Administration
March 1989

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In the United States, as in most developed and developing economies, a completely different business world exists from that measured by cash registers, financial statements, tax forms and government statistics. This is the hidden economy, and it consists of income which is earned in an economy but is not officially reported. Although the terms "hidden" and "underground" connote shady or illegal activity, only a small part of the total income in the hidden economy is derived illegally; most is from otherwise legal but merely unreported or underreported activity. Many economic observers contend that the hidden economy is of staggering size relative to the official economy and that its growth rate may be greater than that of the official economy. This report discusses the causes, size and effects of the hidden economies of the United States and the State of Arkansas.

Causes

There are several reasons for the existence of the underground economy. Bookkeeping ignorance and mistakes probably account for a small fraction of the hidden economy, but much income and activity is hidden by choice. Obviously, most individuals will not report income from illegal activity (drugs, gambling, prostitution, etc.) in order to hinder detection of the income-producing activity. Although sophisticated organized criminals operate somewhat in the official economy when they launder money through legitimate businesses, much illegal income goes unreported.

The most common reason for hiding income and economic activity is to circumvent taxes and government regulation. Income which goes unreported goes untaxed; an individual wanting to avoid high tax rates will save money by hiding income and participating in the underground economy. Others seek to avoid government regulation. For example, a firm employing workers at below the minimum wage will not report its payrolls in order to circumvent labor rules. (This off-the-books labor also relieves the employer of the burden of FICA and unemployment insurance taxes.) A related reason for the hidden economy's existence is taxpayer dissatisfaction with government. A taxpayer who feels his or her money is not being spent efficiently, or disagrees with some government programs may protest by withholding financial support by hiding income or activity subject to taxation.

Methods and Examples

Participants in the hidden economy avoid reporting their activity in various ways. The most common forms of hidden economic activity are moonlighting, barter, skimming, work by illegal aliens, covert rentals and off-the-books inventories and transactions. The following case examples illustrate some common methods and conditions necessary for individuals to be able to participate in the hidden economy:

> An auto mechanic spends weekends repairing friends' cars. He charges them, and they pay him with currency. The mechanic immediately spends the money and forgets the transaction.
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> A house painter agrees to redecorate his dentist's home. In exchange, the dentist fixes the painter's teeth. Neither records the exchange.
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> A restaurant owner routinely eats meals in her restaurant and never pays. She also occasionally takes money from the cash register for personal use and does not record it. Her regular customers often pay in exact change, not requiring her to ring the transaction on the cash register.
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> A retired couple receiving social security payments lives near a popular beach. On weekends, they rent a spare bedroom to tourists.
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> A carpenter spends his spare time building decks onto people's houses. He tells his customers to disregard buying a building permit, and they pay him with currency.

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The emphasis in maintaining hidden operations is to avoid leaving a "paper trail" which auditors may use to find income. A proprietary position helps, as there is no employer to withhold tax from wages, and the proprietor is thus responsible for self reporting. If there are no internal controls in a firm, proprietary skimming of cash off-the-top is even easier. Payments in currency commonly ease informal transactions because cash can be easily and quickly spent. Thus if an informal supplier receives cash for goods or services and gives no receipt (as is common), the transaction becomes lost and impossible to audit later. To ideally hide income, an informal supplier will spend unreported income on non-durable goods or personal services, avoiding obvious asset accumulation or excessive bank account deposits.

Estimating the Size of the Underground Economy

For obvious reasons it is extremely difficult to accurately estimate the size of the underground economy. Economists have, however, proposed several methods of approximation.[1] These methods can be classed as direct methods (which rely on extrapolation of survey data) and indirect methods (which use computations based on monetary or employment statistics). Most methods are at least somewhat limited in their accuracy because of their underlying assumptions or insufficient available data.

The Internal Revenue Service produces an annual estimate of income tax noncompliance which can be used to estimate part of the hidden economy.[2] This estimate is a tax gap estimate based on a sample audit of federal tax returns. The tax gap consists of taxes owed but not paid and will be further discussed later in this report. The IRS only considers income from legal sources (although illegal income is taxable) in its estimates. The IRS estimated that in tax year 1987, individuals and corporations owed but didn't pay $84.9 billion in federal tax. Most of this amount was due to underreported income. If we divide the tax gap estimate by the federal average effective tax rate, we reveal an estimated hidden U.S. economy of $551.7 billion, or 12.3% of the official gross national product. If we assume that the hidden economy is distributed among the states the same as official GNP, we can extrapolate a 1987 hidden economy of Arkansas of $4.1 billion. The IRS estimates probably understate the size of the hidden economy because they only include legal income, and they only include income which their sample audits found. Much of the hidden economy, remember, is unauditable.

Indirect estimation methods tackle the hidden economy problem from a macroeconomic perspective. One of the simpler methods, proposed by Peter M. Gutmann, uses changes in the ratio of outstanding currency to demand deposits to estimate the size of the hidden economy.[3] This method assumes that all hidden transactions are carried out in currency and that outside of growth in the hidden economy, the currency/demand deposit ratio is constant over time. Using Gutmann's method, we can compute a hidden U.S. economy of $501 billion in 1988 or 10.3% of GNP. Applying the method to Arkansas yields a state hidden economy of $4.2 billion in 1988. Although the results of these estimates are quite similar to the IRS figures, the two estimates do not prove each other. Gutmann's method probably understates the hidden economy by ignoring barter and unreported transactions paid for by check.

Effects of a Hidden Economy

The existence of a second economy in addition to an official national or state economy produces many problems for government policy makers. One problem already mentioned is the avoidance of taxes. The IRS study shows a federal income tax gap of $84.9 billion in 1987. If we multiply our estimated Arkansas hidden economy by the state's 1988 net revenue/gross state product ratio of 4.812%, we see that in 1988 Arkansas forfeited at least $170 million in state tax revenue to the hidden economy. This loss of revenue also extends to the local governments. Besides costing the governments potential tax revenue, the tax avoidance of the hidden economy serves to shift the tax burden to those citizens who comply with tax laws. Honest taxpayers in effect pay higher taxes than otherwise necessary in order to make up the difference.

Another major problem governments have because of the hidden economy has to do with decision information.[4] When making policies, government officials must rely upon official information and statistics for decision support. Most official economic statistics do not include activity from the hidden economy. Official figures would, of course, understate GNP. Unemployment would be overstated by official figures which ignore off-the-books labor. Inflation is probably overstated by figures which ignore the hidden economy because costs tend to be lower in the informal sector than the official economy. As stated earlier, it is very difficult to estimate hidden activity, but government officials who ignore the hidden economy may espouse inefficient, ineffective or possibly economically damaging policies.

Conclusion

The United States is home to a hidden, unreported and untaxed economy larger than the official economy of Canada. Although much of the hidden economic activity is otherwise legal, it is done off-the-books in order to elude taxation and regulation. It is difficult to estimate accurately the size of the hidden economy, but it is safe to say that it is a large proportion of GNP. The hidden economy presents significant problems for government in the forms of revenue loss, unfair taxation and faulty decision information. Obviously, government cannot efficiently monitor every transaction in an economy, especially those involving only currency or barter. Thus we might expect that the hidden economy will persist as long as there are dissatisfied taxpayers and taxes and regulations to avoid. We can also expect future growth in the hidden economy as the service sector continues to grow in its economic importance.

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1. Carson, Carol S. "The Underground Economy: An Introduction," *Survey of Current Business*, May 1984.

2. Kenadjian, Berdj. "Gross Tax Gap Trends According to New IRS Estimates, Income Years 1973-1992," *Statistics of Income Bulletin*, Summer 1988.

3. Gutmann, Peter M. "Off the Books," *Across the Board*, August 1978.

4. Feige, Edgar L. "How Big Is the Irregular Economy?" *Challenge*, November/December 1979.